Supreme Court, U.S.
FILED

021291 MAR 3 2003

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No. 02-

IN THE

Supreme Court of the United States

TAX AND ACCOUNTING SOFTWARE CORPORATION, TIM E. KLOEHR, and SHERYL KLOEHR,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the Tenth Circuit's construction of the "discovery" and "process of experimentation" tests of 26 U.S.C. § 41, which provides a tax credit for research and development expenses, is irreconcilably at odds with the legislative history of § 41 and Treasury Department regulations promulgated under the authority of § 41?

2. Whether the Tenth Circuit's failure to consider subsequent legislative history in construing 26 U.S.C. § 41 is in conflict with this Court's decisions, including *Pierce v. Underwood*, 487 U.S. 552 (1988), upon which the Tenth Circuit relied?

PARTIES TO THE PROCEEDING

The following were parties to the proceeding in the courts below: Tax and Accounting Software Corporation, an Oklahoma corporation; Tim E. Kloehr; Sheryl Kloehr; and the United States of America. In addition, the Colorado Software & Internet Association and the Software Finance & Tax Executives Council filed amicus briefs in the Tenth Circuit.

STATEMENT PURSUANT TO RULE 29.6

There is no parent or publicly held company owning 10% or more of the stock of Tax and Accounting Software Corporation.

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The Opinion of the Tenth Circuit is reported as *Tax and Accounting Software Corporation v. United States of America*, 301 F.3d 1254 (10th Cir. 2002). The Opinion of the District Court is reported as *Tax and Accounting Software Corporation v. United States of America*, 111 F. Supp. 2d 1153 (N.D. Okla. 2000).

STATEMENT OF JURISDICTION

The judgment of the Tenth Circuit was entered on August 30, 2002. Pet. App. at 1a. On October 15, 2002, Petitioners timely filed a Petition for Rehearing and Petition for Rehearing En Banc. The Tenth Circuit entered its Order denying rehearing on December 2, 2002. Pet. App. at 48a. The jurisdiction of this Court rests upon 28 U.S.C. § 1254.

STATUTES INVOLVED

The pertinent statutory provisions are set forth at Pet. App. 50a.

INTRODUCTION

In 1981, at a time when the federal budget deficit was swelling, the economy was experiencing stagnant growth and productivity, and the ability of U.S. companies to compete in foreign markets was adversely affected by declines in investment research and development, Congress enacted incentives for private businesses to increase expenditures for research and experimentation as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34, Aug. 13, 1981, Sec. 221), which amended the Internal Revenue Code of 1954 to add a new Section 44F (now 26 U.S.C. § 41). In creating the research and development tax credit to stem declines in spending in the U.S. for research, the Senate Finance Committee specifically stated "[t]he Committee believes that the decline in this country's research and development activities has adversely affected economic growth, productivity gains, and our competitiveness in world markets."

S. Rept. No. 97-144, 97th Cong., 1st Sess., p. 77 (1981). *See also* H. Rep. Rept. No. 97-201, 97th Cong., 1st Sess., p. 111 (1981). This credit was the only business tax provision contained in the Economic Recovery Tax Act of 1981 that targeted the high technology sector's capital spending in the form of investment in research and development activities.[1]

At the time the research and development credit was enacted in 1981, the computer software industry in the United States was in its infancy. By 1985, the earliest year for which statistics are available, the computer software industry had only 55,000 employees and paid total wages of $1.8 billion.[2] Average wages paid to software industry employees in 1985 was $32,933, compared with the average for all workers of $18,843.[3] Five years later, by 1990, total software industry employment had more than doubled, to 112,800, total wages had grown 250% to $5.1 billion, and average wage per employee had grown to $45,505, as compared to the overall average of $23,209.[4] By 1997, total employment in the software industry had grown to almost 230,000 workers, with average annual wages rising to $77,422, compared to the overall average worker wage of $29,787.[5]

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1. The Economic Recovery Tax Act of 1981 contained several other business tax incentives benefiting capital intensive businesses, such as accelerated depreciation of certain business equipment, and changes to the investment tax credit provisions to encourage certain distressed industries to modernize their plants and equipment.

2. *See The Emerging Digital Economy*, U.S. Department of Commerce, April 1998, App. I, Tables 14 and 15 (available at http://www.esa.doc.gov/).

3. *Id.*, at Chart 16.

4. *Id.*, at Charts 14, 15, and 16.

5. *See The Emerging Digital Economy II*, U.S. Department of Commerce, June 1999, App. 2 Chp. IV, Table A-4.1, A-4.3.

In addition to the tremendous growth in the number of high paying jobs, the software industry has been a growing source of exports of U.S. made software products,[6] and has contributed greatly to U.S. economic growth and gains in productivity.[7]

The software industry's contributions to economic growth, productivity, and foreign competitiveness correspond directly with Congress's goal in enacting and extending the research and development tax credit. These contributions have been made through the development of products offering new functionality, *including the products developed by Petitioners in this case for which Petitioners seek to take the tax credit.*

STATEMENT OF THE CASE

Petitioners are Tim Kloehr, his wholly owned Subchapter S corporation Tax and Accounting Software Corporation ("TAASC"), and his wife Sheryl Kloehr. TAASC creates and markets software for use by tax and accounting professionals. During 1993 and 1994, the years at issue here, TAASC developed and further improved four innovative commercial software products:

- *EasyACCT™*, a fully integrated accounting program that collects data for the preparation of financial statements and allows the transfer of this information to TAASC's tax-preparation software. As the Tenth Circuit noted, "[t]he parties agree that at the time of its introduction to the public EasyACCT was unique in the functions it provided." 301 F.3d at 1256.

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6. *The Emerging Digital Economy II*, *id.*, at p. 21.

7. For instance, between 1995 and 1998, information technology producing industries, including the software industry, contributed on average more than one-third of real economic growth. *The Emerging Digital Economy II*, *id.*, at p. 15. In addition, in both 1996 and 1997, declining prices in information technology producing industries, including the software industry, brought overall inflation down by .7 percentage points. *Id.*

- *Professional Tax System*, software which was the first on the market with the ability to integrate the preparation of tax returns for a variety of entities and integrate modules for the preparation of state tax returns using the results of the federal tax calculations. As the Tenth Circuit noted, "[i]t was the first commercial software program to allow for electronic filing with state and federal governments." *Id.*

- *EasyTEL*, a combination of computer hardware and software, used in connection with a public switch telephone network system ("PBX") or with the telephone company's public switch network to answer and transfer telephone calls, take voicemail messages, supply audio text information services, receive and convert fax messages to e-mail, and act as a fax distribution system. "EasyTEL is unusual because it was designed to run on low-cost computer hardware and requires little maintenance." *Id.* at 1256-7.

- *EasyMICR™*, a software program designed to print magnetic ink character banking transit codes on blank check stock. This program was intended for users of *Quicken* and *QuickBooks*, and would allow them to print checks on blank stock so they would not have to buy preprinted check stock from the *Quicken* and *QuickBooks* supplier. TAASC was required to design two programs, one to work in the DOS format and one to work in the Windows format. EasyMICR was a commercial failure, but was subsequently integrated into EasyACCT. *Id.* at 1257.

In 1993 TAASC incurred a total of $1,838,756 in research and development expenses in connection with these software products. In 1994 TAASC incurred a total of $2,444,938 in expenses. Petitioners claimed a portion of these research and development expenses as tax credits under 26 U.S.C. § 41, but

the Internal Revenue Service disallowed the tax credits. Facing tax deficiencies of $123,764 in 1993 and $192,510 in 1994, Petitioners paid the deficiencies and brought a refund suit.

A. The Internal Revenue Code Provisions.

The Internal Revenue Code ("Code" or "IRC") allows taxpayers who increase their research activities over previous years to use a portion of those increased research expenses as a credit against income taxes otherwise due. IRC §§ 38, 41. To qualify for the credit, the research activities must meet the following four tests:

1. The § 174 test: the expenses generated by the research must qualify as research and experimental expenditures under IRC § 174;

2. The discovery test: the research must be undertaken for the purpose of discovering information which is technological in nature;

3. The business component test: the information discovered by the research is intended to be useful in the development of a new or improved business component of the taxpayer; and

4. The process of experimentation test: substantially all of the research activities constitute elements of a process of experimentation related to a new or improved function, performance or reliability or quality.

IRC § 41(d)(1).

Respondent conceded that the work accomplished by Petitioner TAASC met the requirements of the § 174 and business component tests. 301 F.3d at 1258. At issue are the "discovery" and "process of experimentation" tests of § 41(d). *Id.*

B. The Legislative History of the Research Credit.

Before enactment of the research credit, Congress established what became 26 U.S.C. § 174. This section of the Code allows taxpayers to deduct research or experimental expenditures in the year incurred. Absent this provision, taxpayers would be required to capitalize research and experimentation expenditures and amortize them over time.

Section 174 did not specifically define the "research or experimental expenditures" eligible for deduction. The Treasury Department, however, promulgated regulations that defined that statutory term to mean "research and development costs in the experimental or laboratory sense." H. Rep. No. 97-201, 97th Cong., 1st Sess., *reprinted in* 1981-2 C.B. 352, 358 (hereinafter referred to as the 1981 House Report, with citations to the page numbers in the Cumulative Bulletin); Treas. Reg. § 1.174-2(a). This category of expenditures generally includes "all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned," as well as the costs of obtaining a patent on the property developed. *Id.*

In 1981, Congress established for the first time a substantial tax credit for businesses who increased their § 174 research and experimental expenditures from year to year. The House of Representatives intended the credit "to stimulate a higher rate of capital formation and to increase productivity" by providing an incentive "for greater private activity in research." 1981 House Report, p. 358.

Congress determined that "qualified research expenditures" for purposes of the credit meant amounts paid:

> (A) for research for the purpose of **discovering information** which may be potentially useful either

(i) in the development of a new business item for the taxpayer or

(ii) in bringing about a significant improvement in an existing business item of the taxpayer, or

(B) in application of results obtained by research to develop a plan or design either

(i) for a new business item for the taxpayer or

(ii) for a significant improvement in an existing business item.

Id. at 359 (emphasis added). Thus, from its inception the research credit required "discovering information," and the information discovered was tied to the product.[8]

Congress also further defined research "to mean a planned search or critical investigation, including experimentation." To be eligible for the credit, however, "the research must be performed in a field of laboratory science (such as physics or biochemistry), engineering *or technology*." *Id.* at 360 (emphasis added).

The 1981 Senate Report summarized these definitions:

> Subject to certain exclusions,[9] the provision adopts the definition of research used in Code section 174.

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8. The Tenth Circuit's conclusion that under the "discovering information" requirement "the taxpayer must show that he discovered new information and that information *must be separate from the product that is actually developed*," 301 F.3d at 1262 (emphasis added), is completely at odds with the intent of Congress.

9. Those exclusions, not applicable here, were: (1) expenditures for research which is conducted outside the U.S.; (2) research in the social sciences or humanities; and (3) research to the extent that it is funded by any grant, contract, or otherwise by another person (or any governmental entity). 1986 House Report at 177.

> That is, *the term "research and experimental" for purposes of new section 44F has the same meaning, subject to the specified exclusions, as has the term "research or experimental" under section 174.*

S. Rep. No. 97-144, 97th Cong., 1st Sess., *reprinted in* 1981-2 C.B. 412, 441 (referred to as the 1981 Senate Report) (emphasis added). The 1981 Conference Report confirmed that "subject to certain exclusions, *the bill adopts the definition of research as used for purposes of the special deduction rules under section 174.*" H.R. Conf. Rep. No. 97-215, 97th Cong., 1st Sess., *reprinted in* 1981-2 C.B. 481, 495 (referred to as the 1981 Conference Report) (emphasis added).

In 1986 Congress clarified and modified the definition of research for purposes of the § 41 credit. The House Committee believed that some taxpayers had claimed the credit for virtually any expense related to product development, such as post-research activities, adaptation, surveys, and studies, and many of these taxpayers were in industries that did not involve high technology, or its application in developing new or improved products. H. Rep. No. 99-426, 99th Cong., 1st Sess., *reprinted in* 1986-3 C.B. (Vol. 2) 1, 178 (referred to as 1986 House Report). Three areas were addressed by the 1986 amendment:

1. Congress clarified the distinction between research expenditures and certain nonresearch activities such as post-research activities, adaptation, and surveys and studies.

2. Congress confirmed the requirement that the information discovered must be (a) technological in nature and (b) intended to result in a new or improved product.

3. Congress added the requirement that substantially all the activities involved in developing or improving the product must constitute a process of experimentation related to functional aspects of the product.

1986 House Report at p. 178.

The House stated its intent with respect to its new "technological in nature" criteria:

> The determination of whether new or improved characteristics of a business item are technological in nature depends on whether the process of experimentation to develop or improve such characteristics fundamentally relies on principles of the physical or biological sciences, engineering, *or computer science* – in which case the characteristics are deemed technological . . .

1986 House Report at p. 180 (emphasis added).

The House also clarified its intent with respect to its "process of experimentation" criteria:

> The concept of "process of experimentation" means **a process of scientific experimentation *or* engineering activities to design a business item where *the design of the item as a whole is uncertain at the outset***, but instead must be determined by developing one or more hypotheses for specific design decisions, testing and analyzing those hypotheses (through, for example, modeling or simulation), and refining or discarding the hypotheses as part of a sequential design process to develop the overall item.

1986 House Report at p. 180-81 (emphasis added). The 1986 Conference Report further explained that

> The term process of experimentation means a process involving the evaluation of more than one alternative *designed to achieve a result* where the *means of achieving that result is uncertain at the outset.*

H.R. Conf. Rpt. No. 99-841, 99th Cong., 2nd Sess., *reprinted in* 3 C.B. (Vol. 4), 1, 72 (hereinafter referred to as 1986 Conference Report) (emphasis added).

The Congressional reports describing the 1986 reenactment of the research credit establish a number of points critical to the issues before this Court. First, Congress did not identify its requirement for "discovery" of information as a modification of the original tax credit. The requirement for "discovery" was established in IRC § 174, and that requirement was reaffirmed by Congress when it originally established the research credit in 1981. 1981 House Report at p. 360; 1981 Conference Report at p. 441.

Second, Congress defined and expanded upon every new or modified requirement imposed by the 1986 reenactment. "Discovery" of information was not included. The legislative history is thus clear that Congress did not establish a new and heightened discovery test in 1986.

Further, Congress declined to establish a protocol for satisfying the process of experimentation test. It required only that the taxpayer demonstrate that the *methods* of achieving the design goal be uncertain at the outset, and that it evaluate more than one alternative for achieving the goal.

In 1998 Congress passed the Tax and Trade Relief Extension Act of 1998 extending the research tax credit. At that time, Congress gave further express advice on the "process of experimentation" test:

> Activities constitute a process of experimentation, as required for credit eligibility, if they

> involve evaluation of more than one alternative to achieve a result where the means of achieving the result are uncertain at the outset, *even if the taxpayer knows at the outset that it may be technically possible to achieve the result.* Thus, even though a researcher may know of a particular method of achieving an outcome, the use of the process of experimentation to effect a new or better method of achieving that outcome may be eligible for the credit (provided that the research otherwise meets the requirements of section 41, including not being excluded by subsection (d)(4)).

H.R. Conf. Rep. No. 825, 105th Cong., 2nd Sess. 1998 (pp. 3218-22) (emphasis added).

C. Treasury Regulations.

In December 1998, the Treasury Department issued proposed regulations for the research credit. 1 Fed. Reg. Vol. 63, No. 231 66503. In the Spring of 1999 Congress received the comments of taxpayers to the proposed regulations, which comments were addressed primarily to the "discovery" and "process of experimentation" tests. As a result of those comments, which were critical of the regulations as an inaccurate reflection of the legislative intent and as a matter of public policy, Congress joined the opposition to the proposed regulations. When it reenacted and extended the research tax credit in late 1999, Congress "urged" Treasury to act in accordance with the comments it had received on the regulations it had proposed to interpret IRC § 41(d):

> The conferees urge the Secretary to consider carefully the comments he has and may receive regarding the proposed regulations relating to the computation of the credit under section 41(c) and

> the definition of qualified research under section 41(d), particularly regarding the "common knowledge" standard.

H.R. Conf. Rep. No. 478, 106th Cong., 1st Session 1999.

On January 3, 2001, Treasury issued final regulations. T.D. 8930 (66 Fed. Reg. 280). Showing some deference to the recent comments of Congress, these regulations contained changes with respect to the tests at issue in this case. In the preamble to the regulations, Treasury acknowledged the universal criticism that the proposed discovery test articulated in the regulation imposed a requirement that was not mandated by the statute. *Id.* at 281. Treasury stated:

> IRS and Treasury recognize that virtually all research utilizes existing scientific principles and technology. *The requirement that a taxpayer seek to exceed, expand, or refine the common knowledge of skilled professionals does not mean that the tools and principles used in the attempt to achieve the technological advance must themselves be beyond the common knowledge.*

In February 2001, Treasury announced that implementation of these "final" regulations would be postponed for further review. "[U]pon completion of the review, Treasury and IRS will announce changes to the regulations, if any, in the form of proposed regulations." Notice 2001-19. Pursuant to the notice, however, taxpayers may rely upon the final regulations during the pendency of the review.

In December 2001, Treasury announced that after consideration of the statute and legislative history, the court decisions, the 2001 "final" regulations, and the comments received on those regulations, it was proposing revised regulations. Although the revised regulations are proposed to become effective for tax years on or after December 26,

2001, "Treasury and the IRS believe that these rules prescribe the proper treatment of the expenditures they address, and the IRS will not challenge return positions consistent with the proposed regulations." *Id.* at 66367. *The returns at issue here are consistent with the regulations.* These revised regulations are intended to clarify: (1) the statutory requirement that qualified research be "undertaken for the purpose of discovering information which is technological in nature"; and (2) the statutory requirement that qualified research be research "substantially all of the activities of which constitute elements of a process of experimentation". *Id.*

1. The Discovery Test

The preamble to the proposed regulations confirms that Treasury and the IRS agree that the statutory requirement that qualified research be "undertaken for the purpose of discovering information which is technological in nature" was intended only to exclude credit for non-technological research. *Id.* at 66363. The Tenth Circuit's opinion is directly at odds with the regulations, as the preamble expressly concludes: "there should be no 'discovery' requirement in the research credit regulations separate and apart from that already required" by the regulations under § 174. *Id.* at 66363.

2. The Process of Experimentation Test

The new regulations, consistent with the legislative history of § 41(d), provide that a process of experimentation is "a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, *or* the appropriate design of that result, is uncertain at the beginning of the taxpayer's research activities." *Id.* at 66368 (emphasis added). All facts and circumstances surrounding the taxpayer's activities are to be considered. *Id.* The proposed regulations suggest factors

which Treasury believes tend to indicate whether the taxpayer has engaged in a process of experimentation. The factor relevant to software development is:

> Does the taxpayer test and analyze numerous alternative hypotheses to develop a new or improved business component;

Id. at 66368-69.

D. The Lower Court Decisions.

The District Court granted summary judgment to Petitioners. With respect to the discovery test, the District Court found that TAASC performed activities which ascertained or determined information that was new to TAASC and was not generally available to the public, and the process of experimentation utilized in the research relied on principles of computer science and, therefore, was technological in nature. 111 F. Supp. 2d at 1160. Accordingly, the District Court held TAASC's research and development met the discovery test.

With respect to the process of experimentation test, the District Court held TAASC proved it followed a "process of experimentation" because it evaluated more than one alternative to achieve its intended result, where the method of achieving that result was uncertain at the outset. *Id.* at 1161.

The Tenth Circuit reversed the District Court's judgment. With respect to the discovery test, the Tenth Circuit held:

> To summarize, the "discovering information" language of § 41 establishes a separate requirement that the taxpayer must meet in order to qualify for the tax credit. Under that requirement, the taxpayer must show that he discovered new information and that information

> must be separate from the product that is actually developed.

301 F.3d at 1262. Because this position was not urged by either party in the District Court, the Tenth Circuit held the issue was never developed and thus summary judgment was inappropriate on the issue. *Id.* at 1267. In reaching this result, the Tenth Circuit rejected outright Petitioners' position that the § 41 discovery requirement was the same as the one in § 174, even though the new regulations (for which the case was abated in the Tenth Circuit for a period if time) agree with Petitioners' position.

With respect to the process of experimentation requirement, the Tenth Circuit held the taxpayer must show it was uncertain about whether the *end result* of the process of experimentation *was technically feasible* at the time it commenced the research. *Id.* at 1264-5. The Tenth Circuit held Petitioners could not meet this requirement as a matter of law because they conceded in their brief that they believed their goal was "technically feasible," *id.* at 1267, even though the process of achieving the result was uncertain at the outset. In reaching this result the Tenth Circuit misapplied the legislative history of § 41 and the Treasury regulations issued under the authority of § 41.

REASONS FOR GRANTING WRIT

Today, the U.S. economic problems and the rate of capital formation for U.S. businesses are remarkably similar to what the country was experiencing in 1981. Information technology producing industries, including the commercial software industry, are being counted upon to contribute to leading the country back to sounder economic times. Yet, the Tenth Circuit, in the first circuit-court reported decision interpreting and applying key provisions of the research and development tax credit legislation to a commercial software developer, has construed the legislation so narrowly that it

has severely curtailed the application of the credit for commercial software developers.[10] In doing so, the Tenth Circuit ignored congressional intent as set forth in the legislative history of § 41, including subsequent legislative history which directly supports Petitioners' position, and ignored the Treasury Department's own newly proposed regulations, which also directly support Petitioners' position.

Shortly after the Tenth Circuit decided this case, the Seventh Circuit Court of Appeals reached a similar result in *Eustace v. Commissioner of Internal Revenue*, 312 F.3d 905 (7th Cir. 2002). *Eustace* was decided December 13, 2002, and a Petition for Writ of Certiorari to the Seventh Circuit will be filed on or before March 13, 2003. Like the Tenth Circuit, the Seventh Circuit failed to follow the legislative history and Treasury regulations addressing the discovery and process of experimentation tests.

Despite the standard enunciated in Treasury's new regulations, the Tenth Circuit's decision here, coupled with the Seventh Circuit's decision in *Eustace*, renders application of the § 41 tax credit for the commercial software industry inconsistent at best, and at worst threatens to severely curtail the use of the § 41 tax credit altogether.[11] In either event, the

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10. There are reported cases concerning application of the credit for the development of internal use software. *See, e.g., Wicor, Inc. v. United States*, 263 F.3d 659 (7th Cir. 2001); *United Stationers v. United States*, 163 F.3d 440 (7th Cir. 1999); *Wicor, Inc. v. United States*, 116 F.Supp.2d 1028 (E. D. Wis. 2000); *United Stationers, Inc. v. United States*, 982 F.Supp. 1279 (N.D. Ill. 1997); *Norwest Corp. v. Commissioner*, 110 T.C. 454, 1998 WL 341634 (T. C. 1998). Congress addressed internal use software separately in the statute, and imposed additional requirements to claim the credit for research and development expenses in connection with internal use software. *See* 26 U.S.C. §41(d)(4)(E) and regulations promulgated in accordance with that section.

11. That the Tenth Circuit's decision is causing problems with (Cont'd)

incentive Congress sought to give the commercial software industry for economic purposes is virtually destroyed.

Given that the position of the taxpayers in these cases is supported by Congress's intent, as set forth in the legislative history of § 41, and the Treasury Department's newly proposed regulations, and the country is faced with the same economic challenges today as it faced in the early 1980s, this Court should grant certiorari in these two significant decisions, and decide the issues raised. Today, more than ever, the commercial software industry needs the tools Congress gave it to remain one of the fastest growing segments of the U.S. economy and a vital engine of economic growth and productivity.

ARGUMENT

I.

THE TENTH CIRCUIT'S INTERPRETATION OF THE "DISCOVERY TEST" IS DIRECTLY CONTRARY TO CONGRESSIONAL INTENT AND THE TREASURY DEPARTMENT'S NEW PROPOSED REGULATIONS.

Section 41(d)(1) provides the research must be "undertaken for the purpose of discovering information." Petitioners argued the "discovering information" requirement under § 41 has the same meaning as it has for purposes of § 174 of the Code. The Tenth Circuit rejected this argument.

(Cont'd)

practitioners in this area was discussed as recently as October 8, 2002, when Dan Rosen, IRS Large and Mid-Size Business Division Counsel spoke with a panel at the Tax Executives Institute Conference in New York City. It was noted at that time that some practitioners had become concerned the panel's decision will lead IRS agents to determine the tax credit rules contain a separate "discovery" test. Indeed, the BNA article states that "Rosen said [the Tenth Circuit's decision] is seen by practitioners as exacerbating the already difficult issue." *Id.*

The legislative history set forth above directly supports Petitioners' position. The 1981 Senate Report summarized the definitions of § 41, including "discovering information," as follows:

> Subject to certain exclusions, the provision adopts the definition of research used in Code § 174. That is, the term "research and experimental" for purposes of new § 44(F) has the same meaning, subject to the specified exclusions, as has the term "research or experimental" under § 174.

S. Rep. No. 97-144, 97th Cong., 1st Sess., *reprinted* in 1981-2 C.B. 412, 441. The 1981 Conference Report confirmed that "subject to certain exclusions, the bill adopts the definition of research as used for purposes of the special deduction rules under § 174." H.R. Conf. Rep. No. 97-215, 97th Cong., 1st Sess., *reprinted in* 1981-2 C.B. 481, 495. These congressional reports expressly establish that, from the beginning, the credit required the discovery of information, and the criteria for the tax credit was satisfied if the taxpayer qualified for the § 174 deduction.

The Tenth Circuit's formulation of the discovery test that "the taxpayer must show that he discovered new information and that information must be separate from the product that is actually developed," 301 F.3d at 1262, is directly contrary to the legislative history.[12] The 1981 House Report stated that "qualified research expenditures" applied to amounts paid "for research for the purpose of discovering information which may be potentially useful either (i) in the development of a new business item for the taxpayer or (ii) in bringing about a significant improvement in an existing business item of the taxpayer" or "in application of results obtained by

12. The Tenth Circuit's definition was not urged by either party, and is not supported by any legislative history or Treasury regulation.

research to develop a plan or design either (i) for a new business item for the taxpayer or (ii) for a significant improvement in an existing business item." 1981 House Report, p. 359.

Treasury's new proposed regulations for the research and development tax credit are consistent with the § 174 definition. See Credit for Increasing Research Activities, 66 Fed. Reg. 66362, 66363 (Dec. 26, 2001).[13]

Despite these new regulations, the Tenth Circuit rejected the parties' position. The Tenth Circuit concluded that because the Treasury Department had changed its position, the regulations were not entitled to deference. 301 F.3d at 1261. The Tenth Circuit has thus created a dichotomy in the interpretation of § 41's discovery test – the interpretation contained in the Treasury Department regulations (promulgated in accordance with the authority granted the Treasury Department by Congress in the legislation), and the interpretation set forth by the Tenth Circuit in a reported decision. This Court should not permit this dichotomy to exist. The tax laws should be interpreted uniformly and applied consistently.

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13. In the preamble to the proposed regulations, Treasury agrees that the statutory requirement that qualified research be "undertaken for the purpose of discovering information which is technological in nature" was intended only to exclude credit for non-technological research. *Id.* at 66363. The regulation expressly rejects the Tenth Circuit's holding, as the preamble expressly concludes that "there should be no 'discovery' requirement in the research credit regulations separate and apart from that already required" by the regulations under § 174. *Id.*

II.

THE TENTH CIRCUIT'S INTERPRETATION OF THE "PROCESS OF EXPERIMENTATION" TEST MISCONSTRUES THE LEGISLATIVE HISTORY AND THE TREASURY REGULATIONS, RESULTING IN AN IMPROPER CONSTRUCTION OF § 41.

With respect to the "process of experimentation" test, § 41(d)(1) provides that "substantially all" of the research "must constitute elements of a process of experimentation" for a valid purpose under the tax credit. § 41(d)(1)(C). The process of experimentation element raises two issues: (1) whether a taxpayer may use methods that are generally known, and (2) whether the taxpayer must initially believe there is uncertainty as to whether the final result is feasible, or whether the test requires uncertainty as to the means of achieving the desired result (as Petitioners contend). 301 F.3d at 1262-3.

With respect to the first issue, the Tenth Circuit agreed with Petitioners that the "process of experimentation" can include research in which the taxpayer tries alternative methods to achieve a result and all of the methods are already commonly known. 301 F.3d at 1264. The Tenth Circuit properly concluded that "[v]iable alternative methods need not be new to the taxpayer nor must they be generally unknown to the public." *Id.*

With respect to the second issue, however, the Tenth Circuit held the taxpayer must show it was *uncertain* about whether the *end result* of the "process of experimentation" was *technically feasible* at the time the taxpayer commenced the research. *Id.* at 1266. In holding the "process of experimentation" test cannot be met as a matter of law if the taxpayer believes the end result is feasible, the Tenth Circuit misinterpreted previously promulgated IRS regulations and positions, misread the legislative history at the time of the

enactment of § 41, expressly declined to consider subsequent legislative history based upon a misapplication of this Court's precedent, and consequently does not properly state the law.

The Tenth Circuit's decision is significant because if the taxpayer must not know whether the end result is technically feasible at the time the research is commenced, the use of the § 41 research tax credit will be severely curtailed, contrary to the clear expression of Congressional intent to provide an incentive for greater private activity in research. With the downturn in the economy and the resulting scarcity of funds for private research, combined with the cutbacks in taxpayer-funded public research, the incentive Congress sought to give business is as important today as it was in 1981.

A. The Tenth Circuit's interpretation of "process of experimentation" is directly contrary to previously promulgated Treasury regulations.

In its opinion the Tenth Circuit stated:

> In the various versions of the regulations implementing § 41(d)(1), the government implies that the end result may be certain so long as the method of achieving that result is uncertain at the outset. Over time, however, the government has apparently changed its view regarding whether the converse is true – i.e., whether the method of achieving the result may be certain provided that the end result itself is uncertain.

301 F.3d at 1263-4. The Tenth Circuit then quotes from the various regulations. However, what Treasury said in those regulations *was not inconsistent. Treasury has always stated the test in the alternative, i.e.*, "the capability *or* the method of achieving [the] result" of the research, "*or* the appropriate design of that result, [must be] uncertain as of the beginning of the taxpayer's research activities" (66 Fed. Reg. at 66368), and "the capability *or* method of achieving [the] result" of the

research must be "uncertain at the outset" (66 Fed. Reg. at 290). Indeed, nowhere in the briefing before the Tenth Circuit did the Government argue for the result reached by the Tenth Circuit – that Petitioners had to be uncertain the end result was technically feasible. The Tenth Circuit has simply reached a result not supported by the regulations or the position advanced by the Government.

B. The Tenth Circuit's interpretation of "process of experimentation" is directly contrary to congressional intent as expressed through the legislative history of § 41.

The Tenth Circuit held the term "process of experimentation" is ambiguous, and therefore legislative history at the time of the enactment of § 41 should be used to construe the term. Though it cited the proper history, *the Tenth Circuit inexplicably misconstrued it, resulting in the Court failing to interpret the statute properly.*

Keeping in mind that the issue is (1) whether it is the *design* of the item or the *means of achieving the end result* which must be uncertain, or (2) whether it is the *ability to reach the end result* which must be uncertain, the panel cited the legislative history at the time of enactment to support its position that the test is the latter. The Tenth Circuit cited the 1986 House Report defining "process of experimentation":

> a process of scientific experimentation or engineering activities to design a business item ***where the design of the item as a whole is uncertain at the outset***, but instead must be determined by developing one more hypotheses for specific design decisions, testing and analyzing those hypotheses (through, for example, modeling or simulation), and refining or discarding the hypotheses as part of a *sequential design process to develop the overall item.*

> [C]osts of developing a new or improved business item are not eligible for the credit **if the method of reaching the desired objective (the new or improved product characteristics)** ***is readily discernible and applicable as of the beginning of the research activities,*** so that true experimentation in the scientific or laboratory sense would not have to be undertaken to develop, test, and choose **among viable alternatives.**

301 F.3d at 1265 (citing H.R. Rep. No. 99-426, at 180-81 (1986) (emphasis in italics the Tenth Circuit's, emphasis in bold added). As the Tenth Circuit noted, the 1986 Senate Report language is substantially identical, *see* S. Rep. No. 99-313, at 696 (1986), and the 1986 Conference Report used slightly different language, *see* H.R. Rep. Conf. Rep. No. 99-841, at II-72 (stating that a process of experimentation "means a process *involving the evaluation of more than one alternative design to achieve a result where the* ***means of achieving that result*** *is uncertain at the outset").* 301 F.3d at 1265 (emphasis added).

Thus, the entire focus of the 1986 legislative history concerns the *means of achieving the result*, not the end result itself, as it speaks to "the design of the item as a whole is uncertain at the outset," "the method of reaching the desired objective," and "evaluation of more than one alternative designed to achieve a result where the means of achieving that result is uncertain at the outset." Absolutely *nothing* in the 1986 legislative history suggests that the taxpayer must be uncertain whether the *final result* is technically feasible; rather, the taxpayer must be uncertain as to *how to achieve the final result*. The Tenth Circuit's interpretation is inimical to the incentive Congress sought to give by enacting the research tax credit.

The cases cited by the Tenth Circuit as supporting the Government's position have all involved *internal use*

software, as opposed to software for commercial purposes as here. *See United Stationers, Inc. v. United States*, 163 F.3d 440 (7th Cir. 1999); *Norwest Corp. v. Commissioner*, 110 T.C. 454, 1998 WL 341634 (T.C. 1998). 26 U.S.C. § 41(d)(4)(E) specifically provides that qualified research "shall not include . . . [e]xcept to the extent provided in regulations, any research with respect to computer software which is developed by . . . the taxpayer primarily for internal use by the taxpayer. . . ." In *Norwest* the Court stated: "[t]he parties agree that the combination of § 41 and the Conference Report accompanying the TRA 1986 results in a total of seven tests that taxpayers must satisfy to obtain the [research and experimentation] credit with respect to qualified research in the development of internal use software." *Norwest*, 110 T.C. at 488. One of those four additional tests is the "significant economic risk" – or "risk of failure" – test, *which the Tenth Circuit's decision now imposes on commercial software developers with its "technical feasibility" holding*. If Congress intended technical feasibility to be the guidepost under the "process of experimentation" test for commercial software developers, it could have written such a requirement into the law as it did with respect to internal use software. In the absence of such a requirement by Congress, the judiciary should not make such law.

This Court, applying the 1986 legislative history, should hold the "process of experimentation" requirement of § 41 is met when the *means* of achieving the end result is uncertain at the outset, not when the end result itself is uncertain. Any other outcome makes little sense. Businesses are not going to spend scarce research dollars to chase results they do not believe are technically possible to obtain.[14]

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14. For example, NASA surely believed it was technically feasible, *i.e.*, possible, to place a person on the moon when it began its space program. Does that mean NASA did not undergo a process of experimentation, as that term is explained in the 1986 legislative (Cont'd)

C. The Tenth Circuit erred in completely ignoring subsequent legislative history which is directly contrary to the Tenth Circuit's decision.

Even though subsequent legislative history in 1998 and 1999 is *directly contrary* to the Tenth Circuit's interpretation of process of experimentation, and *decisively answers the question in Petitioners' favor*, the Tenth Circuit expressly disregarded it. The Tenth Circuit misapplied this Court's decision in *Pierce v. Underwood*, 487 U.S. 552 (1988), in disregarding this relevant subsequent legislative history.

In examining the applicability of subsequent legislative history in statutory construction, this Court has held that while the views of a subsequent Congress cannot override the unmistakable intent of the enacting one, such views are entitled to significant weight, particularly when the precise intent of the enacting Congress is obscure. *Seatrain Shipbuilding Corp. v. Shell Oil Co.*, 444 U.S. 572, 596 (1980); *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 380-81 (1969). Here, the Tenth Circuit concluded the language of the statute was ambiguous. Therefore, the subsequent legislative history was entitled to significant weight.

At the very least, this Court has held that subsequent legislative history has "persuasive value," and therefore the Tenth Circuit should not have dismissed it outright. *Bell v. New Jersey and Pennsylvania*, 461 U.S. 773, 784 (1983). While this Court has stated that arguments predicated upon

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(Cont'd)
history, to achieve the result of placing a person on the moon? Under the panel's decision, if NASA conceded it believed its goal of placing a person on the moon was technically feasible, *NASA could not meet the process of experimentation requirement even though the means of achieving the end result was uncertain at the outset.* Such a result is clearly contrary to the congressional intent as expressed in the 1986 legislative history.

subsequent congressional actions must be weighed with extreme care, such arguments "should not be rejected out of hand as a source that a court may consider in the search for legislative intent." *Andres v. Shell Oil Co.*, 446 U.S. 657, 666 n.8 (1980).

The Tenth Circuit relied on *Pierce* in outright rejecting consideration of the subsequent legislative history in this case. *Pierce* involved a provision of the 1980 version of the Equal Access to Justice Act which authorized an award of attorney fees against the government unless the Court found the government's position was "substantially justified." The courts had differing interpretations of "substantially justified" (with 12 of 13 interpreting it one way). When the attorney fees provision of EAJA was reenacted without change in 1985, a House committee report indicated approval of the interpretation by the one court. The *Pierce* Court held that if the subsequent legislative history is to be controlling it must either (1) be an authoritative interpretation of what the 1980 statute meant, or (2) be an authoritative expression of what the 1985 Congress intended. The *Pierce* Court held the House committee report could not be an authoritative interpretation of what the 1980 Congress intended because it is the function of the courts and not the Legislature (much less a committee of one House of the Legislature) to say what the statute means. *Id.* at 566. Nor could the House committee report be an authoritative expression of what the 1985 Congress intended because it did not explain any language the 1985 committee drafted, and because there was no indication the 1985 Congress did anything but reenact the 1980 legislation with regard to the attorney fee provision at issue. *Id.* at 567. The *Pierce* Court also noted the subsequent legislative history contradicted the almost uniform appellate interpretation of the provision, and it also contradicted, without explanation, the 1980 House Report from which the lower court in the *Pierce* case drew its conclusion.

Pierce is clearly distinguishable from the circumstances here. Unlike the EAJA, which simply involved the interpretation of a statute, here Congress directed the Treasury Department to promulgate regulations implementing § 41, *including detailing the meaning of "process of experimentation"*. The regulations have evolved over time. Congress is entitled to subsequently express its views on what the regulations should provide, as Congress did in 1998 and 1999. *Under these circumstances, Congress's views are entitled to great weight and should be taken into account.*

Moreover, here the 1998 and 1999 Congress did not need to change the actual wording of § 41 because *the details to be changed were those outlined in Treasury regulations, not the statutory language.*[15] And, the promulgated regulations are consistent with the subsequent legislative history that expresses an intent that the process of experimentation test include research "even if the taxpayer knows at the outset that it may be technically possible to achieve the result." It makes no difference that Congress did not amend the statute in 1998 or 1999 *because it was the regulations that needed clarification* (so that the IRS would not advance a contrary position in litigation).

Thus, *Pierce* is not controlling on the issue of whether subsequent legislative history bears on the interpretation of the statute. The Tenth Circuit, in expressly disregarding the 1998 and 1999 legislative history on the basis of *Pierce*, has decided an important question of federal law in a way that conflicts with relevant decisions of this Court. The subsequent legislative history in this case was entitled to great weight.

Scholars agree that the special nature of tax litigation – its frequency and evolving character – makes subsequent legislative history particularly relevant authority in these

15. *See St. Amour v. Dep't of Social Welfare*, 605 A.2d 1340, 1343 (Vt. 1992) (distinguishing *Pierce* on same basis).

cases. For instance, Michael Livingston, professor at the Rutgers-Camden School of Law, wrote:

> The frequency of tax legislation, and its evolutive character, are perhaps even more relevant for post-enactment history. Frequent legislation suggests that, if courts ignore subsequent expressions of congressional intent, Congress may reverse the result in the next tax bill. The "transaction costs" of ignoring congressional intent are thus particularly high in tax cases. The evolutive character of tax law suggests that new tax provisions will frequently be amendments to old ones (or existing interpretations of old ones); the line between pre- and post-enactment legislative history will thus tend to blur somewhat in tax cases.

Livingston, "*What's Blue & White and Not Quite as Good as a Committee Report: General Explanations and the Role of "Subsequent" Tax Legislative History*, 11 Am. J. Tax. Pol'y 91, 95-96 (1994).[16]

The Court should grant certiorari in this case so that an important question of federal law can be decided in accordance with this Court's pronouncements on the use of subsequent legislative authority to construe ambiguous statutes.

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16. *See also* Brudney, *Congressional Commentary of Judicial Interpretations of Statutes: Idle Chatter or Telling Response*?, 93 Mich. L. Rev. 1, 63-64 (1994). Brudney also points out that courts regularly invoke more contemporary contexts to clarify or update earlier legislative understandings, including post enactment dictionary usage, canons of construction, and agency interpretations. The same considerations that justify reliance on these sources in statutory construction likewise justify reliance on post-enactment legislative history. *Id.* at 65-66.

CONCLUSION

The research and development tax credit is a significant Congressional enactment to provide incentives to address concerns with the national economy. The credit is as significant today for commercial software developers as it was when it was first enacted in 1981. It is only by granting certiorari in this case that an important federal tax law can be interpreted in accordance with Congressional intent and Treasury Department regulations, and the statute can be applied uniformly and consistently to all taxpayers on a national basis to achieve the intent of Congress.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT DATED AND FILED AUGUST 30, 2002

UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

No. 00-5196

TAX AND ACCOUNTING SOFTWARE CORPORATION; TIM E. KLOEHR; and SHERYL KLOEHR,

Plaintiffs - Appellees,

v.

UNITED STATES OF AMERICA,

Defendant - Appellant.

COLORADO SOFTWARE AND INTERNET ASSOCIATION; SOFTWARE FINANCE AND TAX EXECUTIVES COUNCIL,

Amici Curiae.

Appeal from the United States District Court for the Northern District of Oklahoma (D.C. No. 98-CV-363)

Before **LUCERO** and **McWILLIAMS**, Circuit Judges, and **STAGG**, * District Judge.

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* The Honorable Tom Stagg, District Judge for the Western District of Louisiana, sitting by designation.

Appendix A

LUCERO, Circuit Judge.

Plaintiff taxpayers filed a refund suit seeking money allegedly owed them from a tax credit for research and development expenses under I.R.C. § 41. In a matter of first impression in this circuit, we interpret the scope of "qualified research" under I.R.C. § 41, including the requirement in § 41(d)(1) that the taxpayer must intend to "discover[] information" using a "process of experimentation." The district court granted summary judgment to the taxpayers and the government appealed. Our review of this case was abated from January 18, 2002, until May 24, 2002, pursuant to the government's request. We have jurisdiction under 28 U.S.C. § 1291, and we reverse and remand.

I

Plaintiffs—Tim Kloehr, his wholly owned Subchapter S corporation, Tax and Accounting Software Corporation ("TAASC"), and Mr. Kloehr's wife Sheryl Kloehr—filed suit seeking a refund of taxes paid by Mr. Kloehr for his 1993 tax year and by him and his wife for 1994.[1] TAASC is an Oklahoma corporation that develops and sells software for use by tax and accounting professionals. In 1993 and 1994, TAASC developed four computer software products for sale to its customers: EasyACCT, EasyMICR, Professional Tax System, and EasyTEL. The research and development expenses for these four products are at issue in this suit.

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1. The plaintiffs will be collectively referred to as TAASC throughout this opinion.

Appendix A

EasyACCT is an integrated accounting program that collects data for the preparation of financial statements and allows for the transfer of this information to TAASC's tax-preparation software. The parties agree that at the time of its introduction to the public EasyACCT was unique in the functions that it provided.

EasyMICR is a software program designed to print magnetic-ink-character banking transit codes on blank check stock. It was developed in both DOS and Windows versions. A commercial failure, EasyMICR was subsequently integrated into EasyACCT.

Professional Tax System integrates a number of tax-preparation software programs into a single, seamless package and allows for the preparation of tax returns for both state and federal tax forms using the same data. It was the first commercial software program to allow for electronic filing with state and federal governments. The program was also designed to run with minimal memory and therefore is able to run on a wide range of computers.

EasyTEL is an automated, multi-task call-processing system that allows businesses to answer and transfer calls, take messages, provide information over the phone, convert faxes to e-mails, and distribute faxes automatically. EasyTEL is unusual because it was designed to run on low-cost computer hardware and requires little maintenance.

In 1993, TAASC incurred a total of $1,838,756 in research and development expenses for the development of these software products; in 1994, it incurred a total of

$2,444,938 in expenses. TAASC claimed a portion of these expenses as research and development tax credits under I.R.C. § 41, but the Internal Revenue Service ("IRS") disallowed those tax credits. As a result, Mr. Kloehr faced tax deficiencies of $123,764 in 1993 and $192,510 in 1994. Mr. Kloehr paid the deficiencies and brought a refund suit on May 14, 1998 under I.R.C. § 7422(a) and 28 U.S.C. § 1346(a)(1). On the parties' cross-motions for summary judgment, the district court granted summary judgment for TAASC.

We review the district court's grant of summary judgment de novo. *Simms v. Oklahoma ex rel. Dep't of Mental Health & Substance Abuse Servs.*, 165 F.3d 1321, 1326 (10th Cir. 1999). Summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). When applying this standard, we view the evidence and draw reasonable inferences in the light most favorable to the non-moving party. *Simms*, 165 F.3d at 1326. If there is no genuine issue of material fact in dispute, we determine whether the district court correctly applied the substantive law. *Id.*

II

Central to the parties' dispute in this case is what constitutes "qualified research," which entitles a business to a tax credit under I.R.C. § 41. We begin our analysis with an overview of the provisions of I.R.C. § 41(d)(1), which defines "qualified research," and a brief history of the § 41 tax credit.

Appendix A

We initially note that the provision in question, I.R.C. § 41, is separate from the tax code provision that provides for a *deduction* for any "research or experimental expenditures" made by a business. I.R.C. § 174(a)(1). The latter expenditures have been defined by regulation as expenditures for "activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product." Treas. Reg. § 1.174- 2. Our interpretation of the proper scope of the tax credit under § 41 has no bearing on the scope or applicability of the deduction under § 174.

A

Section 41(d)(1) lays out five separate requirements for "qualified research":[2]

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2. The full text of I.R.C. § 41(d)(1) is:

(d) Qualified research defined.—For purposes of this section—

(1) In general.—The term "qualified research" means research—

(A) with respect to which expenditures may be treated as expenses under section 174,

(B) which is undertaken for the purpose of discovering information—

(i) which is technological in nature, and

(ii) the application of which is intended to be useful in the development of a new

(Cont'd)

Appendix A

(1) The research must qualify as expenses under I.R.C. § 174, the tax code provision providing for deductions of research expenses. I.R.C. § 41(d)(1)(A).

(2) The research must be "undertaken for the purpose of discovering information." § 41(d)(1)(B).

(3) The information discovered must be "technological in nature." § 41(d)(1)(B)(i).

(4) The "application" of the information described above must be "intended to be useful in the development of a new or improved business component of the taxpayer." § 41(d)(1)(B)(ii).

(5) "Substantially all" of the research must "constitute elements of a process of experimentation" for a valid purpose under the tax credit.[3] § 41(d)(1)(C).

(Cont'd)

> or improved business component of the taxpayer, and
>
> (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).
>
> Such term does not include any activity described in paragraph (4).

3. The research that qualifies for the § 41 tax credit may only be for certain purposes, listed in I.R.C. § 41(d)(3). The validity of TAASC's research purposes is not at issue in this case.

The government concedes that TAASC has met the first and fourth requirements. The parties also do not dispute that the research undertaken by TAASC was "technological in nature" as required by I.R.C. § 41(d)(1)(B)(i). Thus, we consider only the proper interpretation of requirements two (the "discovering information" requirement) and five (the "process of experimentation" requirement).

B

The tax credit embodied in § 41 was originally codified as § 44F of the Internal Revenue Code and was enacted as part of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 221, 95 Stat. 172, 241-47. Like § 41, § 44F allowed a credit for "qualified research," but unlike § 41, § 44F provided no definition of "qualified research." Instead, the statute simply referred to "qualified research" for purposes of the existing tax deduction under § 174. *See* Pub. L. No. 97-34, § 221, 95 Stat. 172, 242. In 1981, "qualified research" for § 174 had no statutory definition and was defined by Treasury Regulations as "research and development costs in the experimental or laboratory sense." H.R. Rep. No. 97-201, at 110 (1981) (citing Treas. Reg. § 1.174-2(a) (1960) (amended 1994)).

In 1986, Congress reenacted the research tax credit with significant changes, creating the current § 41. The provisions in I.R.C. § 41(d)(1) defining "qualified research" were added, including the "discovering information" requirement and the "process of experimentation" requirement.

Appendix A

Throughout the late 1980s and 1990s, the research tax credit was reenacted without any substantive changes to the relevant provisions. *See* Credit for Increasing Research Activities, 63 Fed. Reg. 66,503, 66,504 (Dec. 2, 1998).

In 1998, Congress reenacted the § 41 tax credit, and the relevant Conference Report included language regarding the definition of "qualified research" in § 41(d)(1). *See* H.R. Conf. Rep. No. 105-825, at 1548 (1998). In 1999, another reenactment of the tax credit prompted more Conference Report language regarding the meaning of § 41(d)(1). *See* H.R. Conf. Rep. No. 106-478, at 132 (1999).

Whether the legislative history is relevant to the disposition of this case, of course, depends on whether the meaning of each statutory requirement is plain. *See United States v. Simmonds*, 111 F.3d 737, 742 (10th Cir. 1997) ("[I]f the statutory language is ambiguous, a court can then resort to legislative history as an aid to interpretation."); *Edwards v. Valdez*, 789 F.2d 1477, 1481-82 (10th Cir. 1986) ("When the meaning of the statute is clear, it is both unnecessary and improper to resort to legislative history to divine congressional intent."). We will later discuss whether the meaning of each contested statutory requirement ("discovering information" and "process of experimentation") is sufficiently plain to preclude consideration of the legislative history.

C

TAASC's interpretation of the "discovering information" test is that it only requires a taxpayer to "discover[ ] technological information that led it to develop innovative . . . products."

(Appellees' Br. at 8.) Alternatively, TAASC argues that the "discovering information" test in § 41 should have the same meaning as it has in the definition of research for purposes of § 174 of the tax code.[4] TAASC also implies that because its products were new and innovative compared with the other commercially available products in the field of tax and accounting software, its research and development expenses for those products therefore must qualify for the tax credit.

The government argues that the 1986 amendments, including the addition of the "discovering information" requirement, were intended to narrow the scope of the tax credit significantly. As a result, to meet the "discovering information" requirement, qualified research must "rely upon, and expand or refine, principles of the physical or biological sciences, engineering or computer science." (Appellant's Br. at 13.) According to the government, TAASC's research did not "expand or refine" principles of computer science, a point that TAASC conceded before the district court. (1 Appellant's App. at 80-81.)

The district court, however, agreed with TAASC that § 41(d)(1) does not require the taxpayer to expand or refine principles of science or engineering in order to qualify for the tax credit. It added that the "emphasis should be on whether the information qualifies as being 'technological in nature' . . . , not whether the work could be considered a

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4. There is no definition of research in the text of § 174. The current Treasury regulations state that an expenditure represents a research cost if it is "intended to discover information that would eliminate uncertainty concerning the development or improvement of a product." Treas. Reg. § 1.174-2(a).

revolutionary discovery in the scientific sense." *Tax & Accounting Software Corp. v. United States*, 111 F. Supp. 2d 1153, 1158 (N.D. Okla. 2000). Indeed, the court reasoned that the allegation that there is a separate requirement that the taxpayer "discover" information is erroneous and a "strained and improper reading without any support in the legislative history to back it up." *Id.* It concluded that as a matter of law TAASC had met the requirements of "discovering information" for purposes of § 41(d)(1), *id.* at 1160, relying in part on the fact that TAASC's products were "new and more efficient combination[s] of software that [were] not available to the public." *Id.*

The parties also disagree whether TAASC's software development process qualifies as a "process of experimentation." TAASC argues that by trying various programming methods in order to achieve its desired results, it undertook a process of experimentation. The government responds that because TAASC used generally known computer programming skills to achieve its final objective, there was no "experimentation," even if TAASC was unsure which particular technique would allow it to achieve its goal.

The government also contends that TAASC did not use a "process of experimentation" because TAASC believed at the outset that the final results of its research—the development of the software—were certain to be technically feasible. According to the government, the "process of experimentation" requirement requires the taxpayer to be uncertain as to whether the final result can be feasibly achieved. The district court concluded that TAASC's research satisfied the "process of experimentation" requirement. *Tax & Accounting Software*, 111 F. Supp. 2d at 1160-61.

Appendix A

III

We first analyze what Congress intended when it required that taxpayers "discover" information in order to qualify for the tax credit. In doing so, we apply traditional tools of statutory construction and interpretation, starting with an overview of the applicable principles.

A

At the time that this case began, the government's interpretation of § 41(d)(1) had not been incorporated into a final regulation that had gone through the notice-and-comment rulemaking process.[5] Under *Christensen v. Harris County*, 529 U.S. 576 (2000), this means that the government's position is only due respect to the extent that it has the " 'power to persuade,' " *id.* at 587 (quoting *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944)), instead of the much greater deference due to regulations promulgated through the Administrative Procedure Act's notice-and-

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5. The government has issued a new set of proposed regulations interpreting § 41(d)(1), superseding regulations that became final in January 2001, but none of these regulations are at issue in this case. *See* Credit for Increasing Research Activities, 66 Fed. Reg. 66,362 (Dec. 26, 2001) (proposed regulations); Credit for Increasing Research Activities, 66 Fed. Reg. 280 (Jan. 3, 2001) (final regulations). Although the regulations are not at issue in this case, we nonetheless consider them as part of our analysis of the respect due the government's position under *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).

comment rulemaking process, *see Chevron, U.S.A., Inc. v. Natural Res. Def. Council*, 467 U.S. 837 (1984).[6]

The respect that is owed to an agency position under *Christensen* and *Skidmore* is based on the "body of experience and informed judgment" that agencies have in the interpretation, enforcement, and implementation of the statutes for which they are responsible. *Christensen*, 529 U.S. at 587; *Skidmore*, 323 U.S. at 140. The respect owed to the agency interpretation "will depend upon the thoroughness evident in its consideration, the validity of its reasoning, [and] its consistency with earlier and later pronouncements." *Skidmore*, 323 U.S. at 140.

The government's position regarding the "discovering information" requirement has been consistent in § 41(d)(1) litigation, *see, e.g., Wicor, Inc. v. United States*, 263 F.3d 659, 660 (7th Cir. 2001); *United Stationers v. United States*, 163 F.3d 440, 444-46 (7th Cir. 1999); *Wicor, Inc. v. United States*, 116 F. Supp. 2d 1028, 1034-36 (E.D. Wis. 2000); *United Stationers, Inc. v. United States*, 982 F. Supp. 1279, 1283-86 (N.D. Ill. 1997); *Norwest Corp. v. Comm'r*, 110 T.C. 454, 492-94 (T.C. 1998), but it has changed significantly as the government has developed regulations to implement § 41(d)(1). *Compare* Credit for Increasing Research Activities, 66 Fed. Reg. 280, 282-84 (Jan. 3, 2001) (stating

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6. The district court applied a *Chevron* analysis in this case. *Tax & Accounting Software*, 111 F. Supp. 2d at 1157. Although its analysis was not explicit, the district court concluded that the language of § 41(d)(1) was plain and contradicted the government's position and that therefore the government's position was foreclosed. *Id.* at 1158-60.

that the "discovery requirement" can only be met when information is discovered that "exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering"), *and* Credit for Increasing Research Activities, 63 Fed. Reg. at 66,504-05 (same), *with* Credit for Increasing Research Activities, 66 Fed. Reg. 66,362, 66,363 (Dec. 26, 2001) (stating that the new proposed regulations "eliminate[] . . . the requirement that qualified research must be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering"). Under *Skidmore* and *Christensen*, we conclude that the government's position is not entitled to substantial deference.

An additional factor to consider is that in construing the Internal Revenue Code, courts are expected to show "respect" and "deference" to the IRS's interpretation of the Code. *See Jewett v. Comm'r*, 455 U.S. 305, 318 (1982); *Callaway v. Comm'r*, 231 F.3d 106, 131 (2d Cir. 2000); *Dewees v. Comm'r*, 870 F.2d 21, 31 (1st Cir. 1989). However, given the IRS's changing position on this issue, we believe that deference is inappropriate here.

Finally, we note that tax credits are "a matter of legislative grace, and taxpayers bear the burden of clearly showing that they are entitled to them." *Schumacher v. United States*, 931 F.2d 650, 652 (10th Cir. 1991) (citing *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)). Thus, they are to be strictly and narrowly construed. *See Texasgulf, Inc. v. Comm'r*, 172 F.3d 209, 214 (2d Cir. 1999); *Inland Steel Co. v. United States*, 677 F.2d 72, 79

(Ct. Cl. 1982). Where there is clear provision in the statute for a particular credit, however, the credit is allowable. *See New Colonial Ice*, 292 U.S. at 440.

B

In interpreting a statute we begin with its plain language. *United States v. Morgan*, 922 F.2d 1495, 1496 (10th Cir. 1991). "In ascertaining the plain meaning of the statute, the court must look to the particular statutory language at issue, as well as the language and design of the statute *as a whole*." *K Mart Corp. v. Cartier, Inc.*, 486 U.S. 281, 291 (1988) (emphasis added).

The word "information" has a broad meaning. *See Webster's Third New International Dictionary Unabridged* 1160 (1993) (defining "information" as, for example, "knowledge communicated by others or obtained from investigation, study, or instruction," or "knowledge of a particular event or situation"). Among other definitions, "discover" can mean "to make known (something secret, hidden, unknown, or previously unnoticed)," "to reveal the identity of," or "to disclose to view (something hidden, covered, or previously unseen)." *Id.* at 647; *see also id.* (stating that the word discover "means to come to know something not previously known, either by purposive search and investigation or by accident"). In the present statutory context, i.e., as one of the requirements for "research" that the government would have an interest in encouraging through a tax credit, we conclude that the word "discover"

requires that what is "discovered"—in this case, information —be something new or previously unknown.[7]

Moreover, the new information that is discovered must also be information that is "intended to be useful in the development of a new or improved business component of the taxpayer." § 41(d)(1)(B)(ii). The new information therefore cannot merely be the product itself but must also have independent value that can be applied in the development of a new product. *Cf. Wicor*, 263 F.3d at 660 (distinguishing, for purposes of § 41, "the domain of genuine research from that of implementation of existing research findings").

In short, the statute requires that the taxpayer's research, in order to qualify, must have developed new information that is applied towards the development of a product. This is the "discovery" requirement of § 41.[8] Contrary to TAASC's

7. This information must not only be new to the taxpayer, but also be information that is generally unknown to the public as well. We cannot conclude that Congress intended to subsidize through tax credits research that might instead have been achieved through a trip to the library or a review of the relevant technical and professional literature. TAASC does not appear to dispute this point. It argues that its programs qualify under the discovery test because "TAASC was the first to make the discovery" that the programs could be developed. (Appellee's Br. at 30.)

8. We reject TAASC's argument that the § 41 discovery requirement should be the same as the one for § 174. We find it difficult to understand how Congress, when it drafted the "discovering information" requirement of § 41 in 1986, intended to adopt a

(Cont'd)

arguments, mere evidence that the taxpayer has developed a new and useful product in and of itself will not qualify. Contrary to the government's argument, the new information need not "expand, or refine, principles of the physical or biological sciences, engineering, or computer science." (Appellant's Br. at 13.) In other words, each of the positions of the parties is incorrect.

More importantly, for our purposes, the district court erred when it held that any "discovery" test was based on a "strained and improper reading without any support," *Tax & Accounting Software Corp.*, 111 F. Supp. 2d at 1158, a holding that essentially read the "discovering information" language out of the statute. The district court also erred when it rejected the argument that the "discovering information" language requires "newness and expansion of existing knowledge." *Id.* at 1159. The term "discovery" means that the researcher must find new information or, in other words, must expand existing knowledge. Finally, the district court erred when it relied on the mere newness and innovation of the product itself, without determining that TAASC

(Cont'd)

definition of "discovering information" that was only developed in the Treasury Regulations *after* § 41 was enacted. *See* Credit for Increasing Research Activities, 66 Fed.Reg. at 66,363; Research or Experimental Expenditures, 58 Fed.Reg. 15,819, 15,820 (Mar. 24, 1993) (proposing the definition of "discovering information" for § 174). TAASC's argument that the "requirement for 'discovery' was established in IRC § 174" and that therefore, by adopting the § 174 definition of research, the original § 44F tax credit also adopted any definition of "discovering information" in § 174, is historically inaccurate. There was no "discovery" requirement in the § 174 regulations until after 1981. *See* H.R. Rep. No. 97-201, at 110.

discovered new information separate from that product, in concluding that TAASC met the requirements of § 41. *Id.* at 1160.

To summarize, the "discovering information" language of § 41 establishes a separate requirement that the taxpayer must meet in order to qualify for the tax credit. Under that requirement, the taxpayer must show that he discovered new information and that information must be separate from the product that is actually developed.[9]

IV

The next issue is whether TAASC's work amounted to a "process of experimentation." We analyze both (1) whether the "process of experimentation" test allows a taxpayer to use methods that are generally known, and (2) whether the test requires the taxpayer initially to believe that there is uncertainty as to whether the final result is feasible.

A

In construing the "process of experimentation" requirement, we again start with the language of the statute. "Process" has a broad meaning that supports TAASC's interpretation. *See Webster's Third New International Dictionary Unabridged* at 1808 (defining process in this context as "a progressive forward movement from one point to another on the way to completion," "the action of passing

9. Because we conclude that the statute's plain meaning addresses the question, we need not reach the parties' legislative history arguments.

through continuing development from a beginning to a contemplated end," "the action of continuously going along through each of a succession of acts, events or developmental stages," or "a particular method or system of doing something, producing something, or accomplishing a specific result").

The definition of "experiment" is "a test or trial," "a tentative procedure or policy," or "an act or operation carried out under conditions determined by the experimenter (as in a laboratory) in order to discover some unknown principle or effect or to test, establish, or illustrate some suggested or known truth." *Id.* at 800.

Here, the definition of "experiment" is ambiguous with respect to the questions at issue. Concerning the first issue, none of the definitions clarifies whether the methods may be generally known. Regarding the second issue, whether the taxpayer must initially believe that there is uncertainty as to whether the final result is feasible, the first two definitions would best fit with TAASC's broad reading of the term. The last definition could support either the government's argument that the final results of the experimental process must be uncertain as to feasibility—the final result being an "unknown principle or effect"—or TAASC's position that the final results may be certain as to feasibility—the final result may also be a "known truth." Given that the "process of experimentation" must be used to discover new information (as we discussed above), however, the government's position regarding this last definition is stronger. New information cannot be a "known truth."

In light of the conflicting definitions, we conclude that the term "process of experimentation" is ambiguous as to the points at issue: namely, whether the final results must be certain as to feasibility and whether the methods to be used in the "process of experimentation" may be generally known. Because of this ambiguity, legislative history may properly be invoked in construing the "process of experimentation" requirement. *See Simmonds*, 111 F.3d at 742 (1997) (discussing the circumstances in which resort to legislative history is appropriate).

B

By all indications, the government has consistently argued in § 41(d)(1) litigation that there must be uncertainty as to whether the final result can be achieved for the "process of experimentation" test to be satisfied. *See, e.g., United Stationers*, 163 F.3d at 445-46; *Wicor*, 116 F. Supp. 2d at 1035-36; *United Stationers*, 982 F. Supp. at 1284-86; *Norwest*, 110 T.C. at 496. However, the government has apparently not raised the issue of whether generally known techniques may be used in the "process of experimentation" in any of these cases.

In the various versions of the regulations implementing § 41(d)(1), the government implies that the end result may be certain so long as the method of achieving that result is uncertain at the outset. Over time, however, the government has apparently changed its view regarding whether the converse is true—i.e., whether the method of achieving the result may be certain provided that the end result itself is uncertain. *Compare* Credit for Increasing Research Activities,

63 Fed. Reg. at 66,508 (stating that the result must be one "where the *means of achieving* that result are uncertain at the outset" (emphasis added)), *with* Credit for Increasing Research Activities, 66 Fed. Reg. at 66,368 (stating that "the *capability or the method of achieving* [the] result" of the research, "or the appropriate design of that result, [must be] uncertain as of the beginning of the taxpayer's research activities" (emphasis added)), *and* Credit for Increasing Research Activities, 66 Fed. Reg. at 290 (stating that "the *capability or method of achieving* [the] result" of the research must be "uncertain at the outset" (emphasis added)).

As for the issue of whether generally known techniques may be used in the "process of experimentation," the government has not addressed that question at all in any of the proposed or final regulations. *See* Credit for Increasing Research Activities, 66 Fed. Reg. at 66,364, 66,368-69; Credit for Increasing Research Activities, 66 Fed. Reg. at 284, 290; Credit for Increasing Research Activities, 63 Fed. Reg. at 66,505, 66,508. Because the government has either taken no position or has altered its position on both issues, its interpretation of the "process of experimentation" requirement is entitled to little deference. *Skidmore*, 323 U.S. at 140.

C

We conclude that the term "process of experimentation" can include research in which the taxpayer tries alternative methods to achieve a result and all of the methods are already commonly known, but it is uncertain which method will allow the taxpayer to achieve the result. As noted above, the

definition of "experiment" does not seem to prohibit the use of commonly or generally known methods. The government has apparently not made the argument that the methods cannot be commonly or generally known in previous litigation, nor has it discussed or considered this interpretation of the statute in its evolving regulations. Nor does the legislative history reflect a contrary legislative intent. Congress stated that a "process of experimentation" would include efforts to "develop, test, and choose among *viable alternatives*." H.R. Conf. Rep. No. 99-841, at II-72 (1986) (emphasis added). Viable alternative methods need not be new to the taxpayer nor must they be generally unknown to the public.

Moreover, as the Treasury Department itself noted in discussing the regulations implementing § 41 early in 2001, "virtually all research utilizes existing scientific principles and technology." Credit for Increasing Research Activities, 66 Fed. Reg. at 283. Most scientific research requires the use of known methodologies to determine whether or not particular results are achievable. Although Congress intended to narrow the scope of the research tax credit in 1986,[10] we conclude that the government's position in this case overstates how narrow Congress intended the research credit to be. Congress did not intend to eliminate the use of already known techniques in the discovery of new information through its narrowing of the tax credit clause.

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10. *See, e.g.*, H.R. Rep. No. 99-426, at 178 (1986) (stating that the prior definition of qualified research had been "applied too broadly in practice" and that the new definition "targets the extended credit").

Appendix A

D

The second issue is whether the taxpayer must show that it was uncertain about whether the end result of the "process of experimentation" was technically feasible at the time that it commenced the research. Courts that have previously decided this issue have generally agreed with the government's position. *See, e.g.*, *United Stationers*, 163 F.3d at 446 (stating that the legislative history strongly suggests that "qualifying research must from its outset involve some technical uncertainty about the possibility of developing the product" and concluding that "debugging programs" alone can not constitute a "process of experimentation" because of the lack of uncertainty as to the final result); *Norwest*, 110 T.C. at 496 (holding that "at the outset uncertainty [must] exist about the ability to develop the product in the scientific or laboratory sense").

The government substantially relies on the legislative history. The 1986 House Report defines "process of experimentation" as:

> a process of scientific experimentation or engineering activities to design a business item *where the design of the item as a whole is uncertain at the outset*, but instead must be determined by developing one or more hypotheses for specific design decisions, testing and analyzing those hypotheses (through, for example, modeling or simulation), and refining or discarding the hypotheses as part of a sequential design process to develop the overall item.

> [C]osts of developing a new or improved business item are not eligible for the credit if the method of reaching the desired objective (the new or improved product characteristics) is *readily discernible and applicable as of the beginning of the research activities*, so that true experimentation in the scientific or laboratory sense would not have to be undertaken to develop, test, and choose among viable alternatives.

H.R. Rep. No. 99-426, at 180-81 (1986) (emphasis added). The 1986 Senate Report language is substantially identical, *see* S. Rep. No. 99-313, at 696 (1986), and the 1986 Conference Report used slightly different language, *see* H.R. Conf. Rep. No. 99-841, at II-72 (stating that a process of experimentation "means a process involving the evaluation of more than one alternative designed to achieve a result where the means of achieving that result is uncertain at the outset"). This legislative history suggests that the credit is inapplicable when the final design is certain at the outset or the taxpayer knows how to achieve the result at the beginning of the claimed research.

TAASC cites subsequent legislative history from 1998 and 1999 to support its position on the issue. Specifically, it notes that during the 1998 reenactment of the tax credit, the conference committee stated that the process of experimentation test included research "even if the taxpayer knows at the outset that it may be technically possible to achieve the result." H.R. Conf. Rep. No. 105-825, at 1548. However, we cannot consider this subsequent legislative history.

Appendix A

In *Pierce v. Underwood*, 487 U.S. 552 (1988), the Supreme Court considered whether legislative history included with the 1985 reenactment of the Equal Access to Justice Act ("EAJA") would control the interpretation of a provision of the 1980 version of the EAJA that was reenacted without change in 1985. The legislative history indicated that Congress approved of the interpretation of that provision of the EAJA by some courts, but not by other courts. The Court held that Congress could not control the interpretation of a statute in that way.

> If this language is to be controlling upon us, it must be either (1) an authoritative interpretation of what the 1980 statute meant, or (2) an authoritative expression of what the 1985 Congress intended. It cannot, of course, be the former, since it is the function of the courts and not the Legislature, much less a Committee of one House of the Legislature, to say what an enacted statute means. Nor can it reasonably be thought to be the latter—because it is not an explanation of any language that the 1985 Committee drafted, because on its face it accepts the 1980 meaning of the terms as subsisting, and because there is no indication whatever in the text or even the legislative history of the 1985 reenactment that Congress thought it was doing anything insofar as the present issue is concerned except reenacting and making permanent the 1980 legislation.

Id. at 566-67.

As was the case in *Pierce*, neither the 1998 nor the 1999 reenactments of the tax credit substantively changed the definition of "qualified research" in the text of the statute. The only reference to the definition was in the legislative history, and that legislative history does not indicate any intent to change the textual meaning of the "process of experimentation" requirement. *See* H.R. Conf. Rep. No. 106-478, at 132 (stating that Congress intended to "reaffirm" the original meaning of the requirement). Congress cannot retroactively change the meaning and intent of previously enacted statutory language through the introduction of legislative history which purports to state what the original meaning of that statutory language was. Congress must change the wording of the statute itself if it wishes to change the meaning of the statute. Following *Pierce*, we will not consider the subsequent legislative history urged upon us by TAASC. *See also Reno v. Bossier Parish Sch. Bd.*, 520 U.S. 471, 484 (1997) (refusing to consider a footnote in subsequent legislative history to the Voting Rights Act because the Court "doubt[ed] that Congress" would amend the statute "by dropping a footnote in a Senate report instead of amending the statute itself"); *Hadden v. Bowen*, 851 F.2d 1266, 1268 (10th Cir. 1988) (refusing to consider subsequent legislative history in connection with the EAJA, following *Pierce*).

Looking to the legislative history for § 44F, the predecessor to § 41, it appears that at least part of the goal of the tax credit is to provide incentives for companies to invest in research that might not otherwise be undertaken because of its high risks. *See* H.R. Rep. No. 97-201, at 111 (suggesting that the § 44F tax credit was intended to encourage businesses otherwise "reluctant to allocate scarce investment funds for

uncertain research").[11] Thus, the very uncertainty of the research is a rationale for the tax credit in the first place. Allowing experimentation to qualify for the tax credit where the feasibility of the final result was certain would undermine that rationale, and might encourage companies to be more conservative in their allocation of resources, concentrating on problems with a solution that is evident from the outset.

TAASC's interpretation of the statute would allow relatively basic activities, such as debugging software, to be included as "experimentation" within the scope of § 41. *See United Stationers*, 163 F.3d at 445. Debugging software often requires the utilization of multiple known methods to eliminate the bug from the software. The software developer often has little or no doubt that one of the methods will eliminate the bug. Thus, without the government's limitation on what "experimentation" can mean, all debugging would qualify for the tax credit. The legislative history quoted above indicates that Congress did not intend such a result. We are further persuaded by the maxim that tax credits are to be narrowly interpreted. *See New Colonial Ice Co.*, 292 U.S. at 440. In enacting the § 41 credit, Congress did not repeal the deduction under § 174, suggesting that less risky research activities were to remain deductible, not creditable.

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11. The conference report for the § 44F tax credit states that the final version enacted by Congress followed the House bill. *See* H.R. Conf. Rep. No. 97-215, at 223-24 (1981).

Appendix A

V

We now apply our legal analysis to the record before us. With respect to the "discovering information" test, much of the record is filled with the conclusory assertions of both parties that the evidence clearly demonstrates that TAASC has, or has not, met the formulation of the test advanced by that party. TAASC's evidence emphasized that its products were new and innovative, and therefore must meet the test; the government's evidence minimized the innovations in TAASC's work. But a crucial question, as shown by our analysis of the plain language of the statute, is whether any new information that TAASC discovered in the course of its research was independent and separate from the new products that it developed. This issue was never developed by either party below, and thus summary judgment for TAASC was inappropriate on this issue.

As for the "process of experimentation" requirement, the affidavits submitted by TAASC under seal indicate to us that TAASC did explore a variety of alternatives to achieve the result in question. However, TAASC has also conceded in its briefs that "TAASC believed . . . [its] goal was technically feasible," at least with respect to the Professional Tax Software project. (Appellee's Br. at 34.) And before the district court, TAASC "acknowledge[d] that its programmers did not question the technical feasibility of the products" in question. (1 Appellant's App. at 77.) TAASC therefore cannot, as a matter of law, meet this requirement.

VI

The judgment of the district court is **REVERSED,** and the case **REMANDED**.

APPENDIX B — ORDER OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF OKLAHOMA DATED AND FILED JULY 31, 2000, AND ENTERED AUGUST 1, 2000

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OKLAHOMA

No. 98-CV-363E

TAX AND ACCOUNTING SOFTWARE CORPORATION, TIM E. KLOEHR AND SHERYL KLOEHR,

Plaintiffs,

v.

UNITED STATES OF AMERICA,

Defendant.

ORDER

Now before the Court are the cross motions for summary judgment of the Plaintiffs, Tax and Accounting Software Corporation, Tim Kloehr and Sheryl Kloehr (collectively referred to as "TAASC") and the Defendant, United States of America (referred to herein as the "IRS").

TAASC creates and sells software programs designed to be used by tax and accounting professionals. This dispute involves tax credits that were claimed by TAASC for tax years 1993 and 1994 under the "research credit" provisions

of § 41 of the Internal Revenue Code for expenses incurred in the creation of such software.

Summary judgment pursuant to Fed.R.Civ.P. 56 is appropriate where "there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." *Celotex Corp. v. Catrett*, 477 U.S. 317, 322-23 (1986); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 250 (1986); *Windon Third Oil & Gas v. FDIC*, 805 F.2d 342 (10th Cir. 1986). In *Celotex*, the court stated:

> The plain language of Rule 56(c) mandates the entry of summary judgment, after adequate time for discovery and upon motion, against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial.

477 U.S. 317 (1986). To survive a motion for summary judgment, nonmovant "must establish that there is a genuine issue of material facts . . ." Nonmovant "must do more than simply show that there is some metaphysical doubt as to the material facts." *Matsushita v. Zenith*, 475 U.S. 574, 585 (1986). The evidence and inferences therefrom must be viewed in a light most favorable to the nonmoving party. *Conaway v. Smith*, 853 F.2d 789, 792 n. 4 (10th Cir. 1988). Unless the Defendants can demonstrate their entitlement beyond a reasonable doubt, summary judgment must be denied. *Norton v. Liddel*, 620 F.2d 1375, 1381 (10th Cir. 1980).

Appendix B

The Tenth Circuit Court of Appeals decision in *Committee for the First Amendment v. Campbell*, 962 F.2d 1517 (10th Cir. 1992), concerning summary judgment states:

> Summary judgment is appropriate if "there is no genuine issue as to any material fact and . . . the moving party is entitled to a judgment as a matter of law." . . . Factual disputes about immaterial matters are irrelevant to a summary judgment determination . . . We view the evidence in a light most favorable to the nonmovant; however, it is not enough that the nonmovant's evidence be "merely colorable" or anything short of "significantly probative."
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> * * *
>
> A movant is not required to provide evidence negating an opponent's claim . . . [r]ather, the burden is on the nonmovant, who "must present affirmative evidence in order to defeat a properly supported motion for summary judgment." . . . After the nonmovant has had a full opportunity to conduct discovery, this burden falls on the nonmovant even though the evidence probably is in possession of the movant. (Citations omitted.)

Id. at 1521.

Appendix B

Facts

The undisputed facts are as follows[1]: TAASC is an Oklahoma corporation and is taxed as a Subchapter S corporation. TAASC develops and markets computer software programs. Tim E. Kloehr is the sole shareholder of TAASC. In 1993, all income of TAASC was reported on Tim Kloehr's individual tax return and in 1994, all income of TAASC was reported on the joint return filed by Tim Kloehr and his wife, Sheryl Kloehr.

During tax years 1993 and 1994, TAASC was in the process of developing four software products, i.e., 1.) EasyACCT an accounting program for use by accounting and business professionals; 2.) EasyMICR, a method of printing bank codes and other information on checks; 3.) the Professional Tax System, a comprehensive system for preparing federal and state returns for a variety of reporting entities for use by accounting professionals; and

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1. The IRS does not dispute the chronology of facts set out in TAASC's affidavits. The IRS criticizes certain characterizations and conclusions drawn by TAASC as to whether a program was "large and complex" or whether certain actions amount to "research" or "experiments" or "discoveries". As pointed out by the IRS, terms such as "large and complex" are relative terms and it is the opinion of the IRS' expert that the programs in question are not "large and complex". This Court does not believe that the determination of "large and complex" is determinative of the outcome of this case. As to a description of the relevant activities of TAASC, the Court prefers to use the terms "develop" or "create" (in the vernacular). Whether such activities rise to the level of the terms of art used in § 41 are ultimately conclusions of law to be determined by the Court.

Appendix B

4.) EasyTEL, a call processing system for use in small to mid-size professional offices.

In the development of EasyACCT, TAASC's design goal was to create a software program which could satisfy the varying needs of a business as well as a professional accounting firm. The EasyACCT software fully integrated a variety of accounting functions and features for both recording transactions and accumulating historic data into one system and allowed data to be transferred between accounting function modules and a tax preparation system. When EasyACCT was introduced, there was no other software system on the market which integrated these abilities. Business and professional accounting firms, therefore, typically were required to use a number of separate programs to perform the variety of tasks required. Critical to TAASC's goal was the ability to design the system within the memory constraints of computer hardware available at the time and maintain the compatibility functions and clean movement between screens and options provided by its separate, less complex programs. TAASC developed a single Invoices/Receivables module to be integrated with the existing system. TAASC intended to design a single transaction feature from which all activities could be recorded, edited and posted. Invoices/Receivables programs on the market at that time featured separate modules for order taking and accounts receivables. The single transaction module would also allow the user to record items in inventory to set up inventory items, another feature unique at that time. These features were included in the release of EasyACCT in 1995.

Appendix B

During 1993, TAASC conducted research for the design of EasyMICR, a program designed to print magnetic ink character banking transit codes on blank check stock. The program was intended for users of Quicken and Quickbooks and would allow them to print checks on blank stock relieving them of the necessity of buying preprinted check stocks from a supplier. TAASC was required to design two programs, one in the DOS format, and one in the Windows format. The research conducted by TAASC lead to significant developments. The DOS program used very little memory, and the Windows' program would run in standard, protected or enhanced modes. Although a technological success, the EasyMICR system was a commercial failure as a stand alone product. It has since been integrated into EasyACCT.

The Professional Tax System is a comprehensive tax preparation software program which prepares returns for a variety of entities such as individuals, corporations, partnerships, trusts and others. Prior to TAASC's development of this system, accountants had to use separate programs to prepare returns for each type of entity. The Professional Tax System combined several programs into a single system. Through that combination, TAASC was able to create many new features to this product that were unavailable in competitive products. As with the EasyACCT accounting system, the integration of these previously independent programs into a single system and the addition of new features resulted in a relatively large and complex program. A critical element of TAASC's design goal, therefore, was to produce a system that minimized the memory space required on a user's computer, and operated at speeds higher than its competitors.

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During 1993 and 1994, TAASC also worked on the development of EasyTEL, an automated multi-tasking call processing system. This product, which combines computer hardware and software, is used in connection with a PBX system or directly with the telephone company's public switched network to answer and transfer telephone calls, take voice mail messages, supply Audiotex information services, receive and convert fax messages to email, and act as a fax distribution system. TAASC's goal in the development of EasyTEL was to produce a product which could perform a large number of tasks simultaneously but have a lower cost per unit than other automated call processing systems. TAASC hoped to achieve this goal by using lower cost hardware and requiring a minimum of administrative maintenance. The use of lower cost hardware, however, required that TAASC overcome certain software design problems. Prior to this design, there were no known products on the market which integrated all of the functions to be placed within the EasyTEL system. The systems then available provided only some of the EasyTEL functions and used very expensive computer hardware and multitasking operating systems. These other systems were very difficult to set up and maintain. They required the use of programming commands and languages to successfully install such a system and additional commands to change or maintain the system. TAASC's goal was to design a system that used readily available low cost parts (such as those used in existing PC computers) and could be installed or maintained by non-technical individuals.[2]

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2. The affidavits submitted to the Court under an Agreed Confidentiality Order contain descriptions of numerous experiments (Cont'd)

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The EasyACCT system and Professional Tax System designed by TAASC enjoyed commercial success, having 6959 customers in 1994, 9887 customers in 1995 and 12,146 customers in 1996. In 1993, TAASC incurred a total of $1,838,756 in research development expenses for the above described software products. Likewise, the research and development expenses were $2,444,938 in 1994. The IRS allowed these expenses to be used as deductions under § 174, but disallowed the same expenses as a credit under § 41. TAASC has paid all taxes owed for 1993 and 1994 and has submitted refund claims in the amount of $123,764 for 1993 and $192,510 for 1994.

ANALYSIS

The Court's task herein is to determine whether any or all of the pertinent software development activities of TAASC constitute "qualified research" for purposes of the tax credit provided by § 41 of the Internal Revenue Code (26 U.S.C. § 41(d)(1)). The tax code sets out several tests that must be met for "qualified research". First, the research must have qualified as a business deduction under § 174. See *id.* § 41(d)(1)(A). Second, the research must be undertaken to "discover information which is technological in nature." *Id.* § 41(d)(1)(B)(i). Third, the taxpayer must intend to use the information to develop a new or improved business

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(Cont'd)

and tests that were conducted in an effort to achieve the goals set by TAASC on each of the software systems. Because of the agreed proprietary and confidential nature of the descriptions in the affidavits, the Court will not attempt to describe those acts in this Order.

component. *Id.* § 41(d)(1)(B)(ii). Finally, the taxpayer must pursue a "process of experimentation" during substantially all of the research. *Id.* § 41(d)(1)(C).[3]

There have been very few reported cases construing the § 41 credit as it applies to the creation of computer software programs. Two cases have analyzed the tests of § 41 as they pertain to software that has been created for the "internal use" of the taxpayer. *Norwest Corporation and Subsidiaries v. Commissioner of Internal Revenue*, 110 T.C. 454, (1998); *United Stationers, Inc. v. United States*, 982 F. Supp. 1279 (N.D. Ill. 1997), *affirmed* 163 F.3d 440 (7th Cir. 1998). There have been no reported cases applying § 41 to software which has been created to be licensed commercially.

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3. The term "qualified research" means research—

(A) with respect to which expenditures may be treated as expenses under section 174,

(B) which is undertaken for the purpose of discovering information—

(i) which is technological in nature, and

(ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and

(C) substantially all of the activities of which constitute elements of a process of experimen-tation for a purpose described in paragraph (3).

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Section 41 is construed much more strictly for "internal use" software than it is for "commercial" software and requires that seven tests must be met for "internal use" software rather than the four stated above. *Norwest*, supra, at 456. While the courts' analyses contained in *Norwest* and *United Stationers* were very helpful to this Court on the requirements of § 41, the Court does not believe that those cases fully comply with the Congressional intent of § 41 and are not applicable to cases involving software developed for the commercial market.

In the case of *Chevron, U.S.A. v. Natural Resources Defense Council*, 467 U.S. 837, 104 S. Ct. 2778 (1984), the United States Supreme Court established a two-step method for judicial review of an agency's interpretation of a statute that it administers. The *Chevron* Court relied on the principle that policy choices are for the political branches of government, and Congress is the supreme branch for making such choices. Under *Chevron*, however, courts retain their traditional role to interpret statutes.

Reviewing courts must first use "traditional tools of statutory construction" to determine whether "Congress has directly spoken to the precise question at issue." 467 U.S. at 843, 104 S. Ct. at 2782. If Congress has clearly expressed its intent in the plain language of the statute, the Court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If the language of the statute is determined to be either ambiguous or silent on the particular issue, the reviewing court is free to proceed to the second

inquiry of *Chevron*, *i.e.*, whether the agency's interpretation is based on a permissible construction of the statute.[4]

A. The "Section 174" and the "Business Component" Tests

The § 174 test requires that the research expenditures qualify as expenses under § 174 of the Internal Revenue Code. Section 174 generally allows as a current deduction, research and experimental expenditures which are paid or incurred by the taxpayer in connection with the operation of a trade or business. In the present case, the parties agree that TAASC has met this test.

In addition, the "business component test" requires that the research be undertaken for the purpose of discovering information the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. TAASC has submitted evidence that the activities in question "relate to a new or improved function, performance, reliability or quality of a product". H. Conf.

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4. See, e.g., *City of Chicago v. Environmental Defense Fund*, 511 U.S. 328, 114 S. Ct. 1588, 128 L.Ed.2d 302 (1994). The Supreme Court stated the threshold inquiry in *Chevron* in terms of whether Congress has unambiguously foreclosed the interpretation offered by an agency. See *MCI Telecommunications Corp. v. American Tel. & Tel. Co.*, 512 U.S. 218, 114 S. Ct. 2223 (1994) (concluding that the agency interpretation went "beyond the meaning that the statute can bear"); *Environmental Defense Fund*, 511 U.S. at 334, 114 S. Ct. at 1594, 128 L.Ed.2d at 312 (same for interpretation that went "beyond the scope of whatever ambiguity" existed); and *John Hancock Mutual Life Ins. Co. v. Harris Trust and Savings Bank*, 510 U.S. 86, 114 S. Ct. 517, 126 L.Ed.2d 524 (1993) (same for interpretation that "exceeded the scope of available ambiguity").

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Rept. 99-841 (Vol.II), 1986-3. The IRS does not challenge TAASC's assertion or evidence that it has met this test.

B. The "Technology" or "Discovery" Test

Section 41 requires that the research activity in question be for the purpose of "discovering information that is technological in nature". The IRS and the Courts in *Norwest* and *United Stationers* have erroneously tried to divide this requirement into two tests with the first being whether the taxpayer's actions can be considered a "discovery" in the scientific sense (the "Discovery Test"). However, that construction of the statutory language would be a strained and improper reading without any support in the legislative history to back it up. The emphasis should be on whether the information qualifies as being "technological in nature" (the Technology Test), not whether the work could be considered a revolutionary discovery in the scientific sense. The statutory language was intended to differentiate between information that is technologically based from that which is non- technologically based. As stated by Congress in 1986:

> The determination of whether research is undertaken for the purpose of discovering information that is technological in nature depends on whether the process of experimentation utilized in the research *fundamentally relies on principles of the physical or biological sciences, engineering, or computer science* — in which the information is deemed technological in nature —or on other principles, such as economics — in which case the

> information is not to be treated as technological in nature. (Emphasis added)

H.R. Conf. Rep. No. 99-841, Vol II at 71 (1986).

Although the word "discovery" is susceptible of conveying several meanings, "discover", "determine", "ascertain", "detect" "unearth" and "learn" are synonyms and are treated as such in common usage.[5] Common usage provides acceptable grounds on which to divide statutory terms into primary, secondary, and other meanings.[6] The Court does not agree with the IRS's contention that this Court should ignore the common usage of certain words in favor of a "scientific" meaning.[7]

The IRS argues that in order for research to pass the "Discovery" test, it requires "newness and expansion of existing knowledge". Furthermore, the regulations created by the IRS require "obtaining knowledge that exceeds, expands, or refines the common knowledge of skilled

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5. See Webster's Third New International Dictionary, p. 647

6. See, e.g., *Mallard v. United States Dist. Court*, 490 U.S. 296, 301, 109 S. Ct. 1814, 1818, 104 L.Ed.2d 318 (1989) *Ardestani v. I.N.S.*, 502 U.S. 129, 112 S. Ct. 515, 519, 116 L.Ed.2d 496, 504 (1991), *John Doe Agency v. John Doe Corp.*, 493 U.S. 146, 153, 110 S. Ct. 471, 476, 107 L.Ed.2d 462 (1989).

7. The IRS also contends that some of the terms used by the Plaintiff's in their briefs are used in their vernacular sense when, in fact, the court should follow the "scientific" definition to determine whether the Plaintiffs' actions meet the required burden.

professionals in the particular field of technology or science". Proposed Reg.Sec. 1.41- 4(a)(3). However, there is no support for this position in the statute or the legislative history. The purpose of the "technology" requirement of § 41 is to eliminate the "soft sciences" from contention for the credit, not to focus on the word "discovery".

The Court is further persuaded by the fact that subsequent to the decision in *Norwest* and *United Stationers*, Congress stated:

> . . . However, eligibility for the *credit does not require that the research be successful* — i.e., the research need not achieve its desired result. Moreover, evolutionary research activities intended to improve functionality, performance, reliability, or quality are eligible for the credit, as are research activities intended to achieve a result that has already been achieved by other persons but is not yet within the common knowledge (e.g., freely available to the general public) of the field . . . (Emphasis Added)

H.R. Conf. Rep. 105-825, at 2 (1998)

While Congressional comments which are post-enactment do not have the weight of contemporary legislative history, the Court would be remiss in its duties if it were to ignore evidence of Congressional intent.[8] In the statement above, Congress states that the research does not have to be successful and it need not achieve its "desired result". While it is possible

8. *Michigan United Conservation Clubs v. Lujan, et al.*, 949 F.2d 202 (6th Cir.1991)

to "expand the existing knowledge" with unsuccessful research, this Court believes that the criteria championed by the IRS and the regulations cited above are somewhat inconsistent with Congress's statement that the research does not need to achieve its intended result.[9]

Similarly, Congress has voiced disagreement with the IRS's assertion that the research must "obtain knowledge that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of technology or science". When recently extending the life of § 41, Congress made it clear that the IRS's regulations do not follow the intent of Congress.

In H.R. Conf. Rep. No. 478, 106th Cong., 1st Sess.1999, the Senate and House Conferees state:

> The conferees wish to reaffirm that qualified research is research undertaken for the purpose of discovering new information which is technological in nature. For purposes of applying this definition, *new information is information that is new to the taxpayer*, is not freely available to the general public, and otherwise satisfies the requirements of section 41. Employing existing technologies in a particular field or relying on existing principles of engineering or science is qualified research, if such activities are otherwise

9. The phrase used is "evolutionary research", not "revolutionary research". This suggests to the Court a pattern of research that is unfolding in a series of events rather than something that is a radical change from the norm.

taken for purposes of discovering information to satisfy the other requirements of section 41. (Emphasis added)

Some of the documentation submitted to the Court by the IRS shows that TAASC and the software vendors who are their competition, were all trying to develop "suites" of software applications or applications that were integrated with each other[10]. The IRS's documentation also shows that this was something that had previously not been available to the public. It is not required that TAASC be the first to learn how to integrate the respective accounting functions, nor is it required that the technologies used be nonexistent at the time. TAASC was using existing technologies to develop integrated accounting and tax software that operated within certain RAM requirements. The evidence shows that this final product was a new and more efficient combination of software that was not available to the public and that the competition was stiff to develop and bring such a product to the market. The Court finds that TAASC has performed activities which have ascertained or determined information that was new to TAASC, and was not generally available to the public, where the process of experimentation utilized in the research fundamentally relies on principles of computer science, and is, therefore, technological in nature.

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10. See Appendix C to the United State's Opposition to Plaintiff's Motion for Summary Judgment.

Appendix B

C. The Process of Experimentation Test

The process of experimentation test requires that substantially all of the activities which constitute elements of a process of experimentation relate to a new or improved function, performance, reliability, or quality. The process of experimentation test is explained by Congress as follows:

> The term process of experimentation means a process involving the *evaluation of more than one alternative* designed to achieve a result where the means of achieving that result is uncertain at the outset. This may involve developing one or more hypotheses, testing and analyzing those hypotheses (through, *for example*, modeling or simulation), and refining or discarding the hypotheses as part of a sequential design process to develop the overall component. Thus, for example, costs of developing a new or improved business component are not eligible for the credit if the method of reaching the desired objective (the new or improved product characteristics) is readily discernible and applicable as of the beginning of the research activities, so that true experimentation in the scientific or laboratory sense would not have to be undertaken to develop, test, and choose among the viable alternatives. On the other hand, costs of experiments undertaken by chemists or physicians in developing and testing a new drug are eligible for the credit because the researchers are engaged in scientific experimentation. Similarly, engineers who design

> a new computer system, or who design improved or new integrated circuits for use in computer or other electronic products, are engaged in qualified research *because the design of those items is uncertain at the outset and can only be determined through a process of experimentation relating to specific design hypotheses and decisions as described above.* (Emphasis Added)

H.R. Conf. Rep. 99-841 at Section C, Page 4.

Again in 1998, Congress attempted to give additional guidance on its intent as to the requirement of a "process of experimentation", when it stated:

> Activities constitute a process of experimentation . . . if they involve evaluation of more that one alternative to achieve a result where the means of achieving the result are uncertain at the outset, *even if the taxpayer knows at the outset that it may be technically possible to achieve the result.* Thus, even though a researcher may know of a particular method of achieving an outcome, the use of the process of experimentation to effect a new or better method of achieving that outcome may be eligible for the credit . . . outcome, the use of the process of experimentation to effect a new or better method of achieving that outcome may be eligible for the credit . . . . (Emphasis Added)

H.R. Conf. Rep. 105-825, at 3 (1998)

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The credit was established as an incentive to encourage taxpayers to incur the cost of research in developing new products and stimulating the economy. The IRS is proposing standards that would be suitable for academic research where the research is going to be published and replicated under the peer review process. However, the IRS is completely missing the fact that Congress intended to encourage commercial research, not academic research. In the commercial environment, time and secrecy are of the essence if the product is going to succeed. The highly structured definition of research which is proffered by the IRS in its regulations makes it virtually impossible for commercial research to qualify for the § 41 credit, which was clearly not the intention of Congress. TAASC has proven that it followed a "process of experimentation" where it evaluated more than one alternative to achieve its intended result, where the process of achieving that result was uncertain at the outset.[11] TAASC had a goal of developing certain integrated suites of software applications that were not available to the public in that form, and which operated within certain limitations of available memory and processing power. TAASC knew at the outset that there were many alternative methods of designing the programming of each component and such would need to be tested, redesigned, refined and maybe eliminated in order to reach the final satisfactory product. TAASC followed a "process of experimentation" in order to reach their final product.

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11. The IRS and its expert argue that "a process of experimentation" cannot include "trial and error". However, this position is inconsistent with Preamble to the IRS's proposed regulations where testing and analysis can be conducted through "modeling, simulation, or a systematic trial and error methodology". 63 FR 66505

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IT IS THEREFORE ORDERED ADJUDGED AND DECREED that the Plaintiff's Motion for Summary Judgment is hereby granted and the Defendant's Motion for Summary Judgment is denied.

Dated this 31st day of July, 2000.

s/ James O. Ellison
JAMES O. ELLISON, SENIOR JUDGE
UNITED STATES DISTRICT COURT

APPENDIX C — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT DENYING PETITION FOR REHEARING DATED AND FILED DECEMBER 2, 2002

UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

No. 00-5196

TAX AND ACCOUNTING SOFTWARE CORPORATION; TIM E. KLOEHR and SHERYL KLOEHR,

Plaintiffs - Appellees,

v.

UNITED STATES OF AMERICA,

Defendant - Appellant.

COLORADO SOFTWARE AND INTERNET ASSOCIATION; SOFTWARE FINANCE AND TAX EXECUTIVES COUNCIL,

Amici Curiae.

ORDER

Filed December 2, 2002

Appendix C

Before **LUCERO** and **McWILLIAMS**, Circuit Judges, and **STAGG,*** District Judge.

Appellants' petition for rehearing is denied.

The petition for rehearing en banc was transmitted to all of the judges of the court who are in regular active service. As no member of the panel and no judge in regular active service on the court requested that the court be polled, that petition is denied.

Entered by the Court
PATRICK FISHER, Clerk of Court

by: s/ [illegible]
Deputy Clerk

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* The Honorable Tom Stagg, District Judge for the Western District of Louisiana, sitting by designation.

APPENDIX D — RELEVANT STATUTES

26 U.S.C.A. § 41

§ 41. Credit for increasing research activities

* * *

(d) Qualified research defined.—For purposes of this section—

(1) In general.—The term "qualified research" means research—

(A) with respect to which expenditures may be treated as expenses under section 174,

(B) which is undertaken for the purpose of discovering information—

(i) which is technological in nature, and

(ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and

(C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).

Such term does not include any activity described in paragraph (4).

Appendix D

(2) Tests to be applied separately to each business component.—For purposes of this subsection—

(A) In general.—Paragraph (1) shall be applied separately with respect to each business component of the taxpayer.

(B) Business component defined.—The term "business component" means any product, process, computer software, technique, formula, or invention which is to be—

(i) held for sale, lease, or license, or

(ii) used by the taxpayer in a trade or business of the taxpayer.

(C) Special rule for production processes.—Any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced).

(3) Purposes for which research may qualify for credit.—For purposes of paragraph (1)(C)—

(A) In general.—Research shall be treated as conducted for a purpose described in this paragraph if it relates to—

(i) a new or improved function,

(ii) performance, or

(iii) reliability or quality.

(B) Certain purposes not qualified.—Research shall in no event be treated as conducted for a purpose described in this paragraph if it relates to style, taste, cosmetic, or seasonal design factors.

(4) Activities for which credit not allowed.—The term "qualified research" shall not include any of the following:

(A) Research after commercial production.—Any research conducted after the beginning of commercial production of the business component.

(B) Adaptation of existing business components.—Any research related to the adaptation of an existing business component to a particular customer's requirement or need.

(C) Duplication of existing business component.—Any research related to the reproduction of an existing business component (in whole or in part)

from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.

(D) Surveys, studies, etc.—Any—

(i) efficiency survey,

(ii) activity relating to management function or technique,

(iii) market research, testing, or development (including advertising or promotions),

(iv) routine data collection, or

(v) routine or ordinary testing or inspection for quality control.

(E) Computer software.—Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in—

(i) an activity which constitutes qualified research (determined with regard to this subparagraph), or

(ii) a production process with respect to which the requirements of paragraph (1) are met.

(F) Foreign research.—Any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

(G) Social sciences, etc.—Any research in the social sciences, arts, or humanities.

(H) Funded research.—Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

* * * *

Appendix D

26 U.S.C.A. § 174

§ 174. Research and experimental expenditures

(a) Treatment as expenses.—

(1) In general.—A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

(2) When method may be adopted.—

(A) Without consent.—A taxpayer may, without the consent of the Secretary, adopt the method provided in this subsection for his first taxable year—

(i) which begins after December 31, 1953, and ends after August 16, 1954, and

(ii) for which expenditures described in paragraph (1) are paid or incurred.

(B) With consent.—A taxpayer may, with the consent of the Secretary, adopt at any time the method provided in this subsection.

Appendix D

(3) Scope.—The method adopted under this subsection shall apply to all expenditures described in paragraph (1). The method adopted shall be adhered to in computing taxable income for the taxable year and for all subsequent taxable years unless, with the approval of the Secretary, a change to a different method is authorized with respect to part or all of such expenditures.

(b) Amortization of certain research and experimental expenditures.—

(1) In general.—At the election of the taxpayer, made in accordance with regulations prescribed by the Secretary, research or experimental expenditures which are—

(A) paid or incurred by the taxpayer in connection with his trade or business,

(B) not treated as expenses under subsection (a), and

(C) chargeable to capital account but not chargeable to property of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion), may be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a

deduction ratably over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the taxpayer first realizes benefits from such expenditures). Such deferred expenses are expenditures properly chargeable to capital account for purposes of section 1016(a)(1) (relating to adjustments to basis of property).

(2) Time for and scope of election.—The election provided by paragraph (1) may be made for any taxable year beginning after December 31, 1953, but only if made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The method so elected, and the period selected by the taxpayer, shall be adhered to in computing taxable income for the taxable year for which the election is made and for all subsequent taxable years unless, with the approval of the Secretary, a change to a different method (or to a different period) is authorized with respect to part or all of such expenditures. The election shall not apply to any expenditure paid or incurred during any taxable year before the taxable year for which the taxpayer makes the election.

(c) Land and other property.—This section shall not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of property to be used

in connection with the research or experimentation and of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion); but for purposes of this section allowances under section 167, and allowances under section 611, shall be considered as expenditures.

(d) Exploration expenditures.—This section shall not apply to any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas).

(e) Only reasonable research expenditures eligible.—This section shall apply to a research or experimental expenditure only to the extent that the amount thereof is reasonable under the circumstances.

(f) Cross references.—

(1) For adjustments to basis of property for amounts allowed as deductions as deferred expenses under subsection (b), see section 1016(a)(14).

(2) For election of 10-year amortization of expenditures allowable as a deduction under subsection (a), see section 59(e).

APPENDIX E — HOUSE BILL CONFERENCE REPORT NO. 99-841

House Bill

* * *

a. Expiration date

The House bill extends the research tax credit for an additional three years (i.e., for expenditures through December 31, 1988), with modifications.

b. Rate

The rate of the credit is reduced from 25 percent to 20 percent.

c. Research definition

The committee report on the House bill clarifies that the credit does not apply to expenditures for certain nonresearch activities (activities occurring after the beginning of production; adaptation of an existing product; and studies and surveys). In addition, the report modifies the definition of credit-eligible research (effective for taxable years beginning after 1985) to target the credit to research undertaken to discover information that is technological in nature and that pertains to functional aspects of products.

d. Qualified expenditures

The House bill generally repeals the present-law provision under which rental or other payments for the right to use personal

property in conducting qualified research are eligible for the credit. However, under regulations prescribed by the Treasury, payments to persons other than the taxpayer for the right to use (time-sharing) a computer in the conduct of a qualified research will remain eligible for the incremental research credit to the extent allowable under present law.

e. University basic research credit

Under the House bill, a 20-percent tax credit applies to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, as adjusted for inflation.[1]

The amount of credit-eligible basic research expenditures to which the new university basic research credit applies does not enter into the computation of the incremental credit. The remaining amount of credit-eligible basic research expenditures—i.e., the amount to which the new credit does not apply—enters into the incremental credit computation (and in subsequent years enters into the base period amounts for purposes of computing the incremental credit).

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1. The House bill provides a single research credit amount, consisting of a 20-percent incremental component and a 20-percent university basic research component. For convenience, this document generally refers to these components as the incremental research credit and the university basic research credit.

Appendix E

f. Credit use limitation

The House bill makes the credit subject to the general limitation on business credits, as amended by the bill (see II. B., above).

g. Effective date

These provisions are effective for taxable years beginning after December 31, 1985.

Senate Amendment

a. Expiration date

The Senate amendment extends the research tax credit for an additional four years (i.e., for expenditures through December 31, 1989), with modifications.

b. Rate

No provision (i.e., the rate of the incremental credit remains at 25 percent).

c. Research definition

The Senate amendment adopts the same general approach as under the House bill, except that the principal definitional rules (effective for taxable years beginning after 1985) are set forth in statutory language. Thus, the credit is targeted to research undertaken to discover information that is

technological in nature and that pertains to functional aspects of products. Also, the Senate amendment expands the present-law statutory list of credit exclusions to include expenditures for the types of nonresearch activities excluded under the language of the House committee report.

d. Qualified expenditures

No provision (i.e., rental or other payments for research use of laboratory equipment, computers, or other personal property remain eligible for the incremental credit).

e. University basic research credit

The Senate amendment is the same as the House bill.

f. Credit use limitation

The Senate amendment is the same as the House bill.

g. Effective date

The provision extending the credit applies to taxable years ending after December 31, 1985. The provisions relating to the research definition, university basic research credit, and the credit use limitation apply for taxable years beginning after December 31, 1985.

Appendix E

Conference Agreement

a. Expiration date

The conference agreement follows the House bill; i.e., the research credit is extended for an additional three years, with modifications.

b. Rate

The conference agreement follows the House bill; i.e., the rate of the research credit is reduced to 20 percent.

c. Research definition

The conference agreement generally follows the approach of the House bill and the Senate amendment, with statutory provisions as to the definition of qualified research for purposes of the credit, as follows.

In general

As under present law, the conference agreement limits research expenditures eligible for the incremental credit to "research or experimental expenditures" eligible for expensing under section 174. Thus, for example, the credit is not available for (1) expenditures other than "research and development costs in the experimental or laboratory sense," (2) expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or

promotions," (3) costs of acquiring another person's patent, model, production, or process, or (4) research expenditures incurred in connection with literary, historical, or similar projects (Treas. Reg. sec. 1.174-2(a)).[2] The term research includes basic research.

Under the conference agreement, research satisfying the section 174 expensing definition is eligible for the credit only if the research is undertaken for the purpose of discovering information (a) that is technological in nature, and also (b) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. In addition, such research is eligible for the credit only if substantially all of the activities of the research constitute elements of a process of experimentation for a functional purpose. The conference agreement also expressly sets forth exclusions from eligibility for the credit for certain research activities that might otherwise qualify and for certain nonresearch activities.

Technological nature

The determination of whether the research is undertaken for the purpose of discovering information that is technological in nature depends on whether the process of experimentation utilized in the research fundamentally relies on principles of the physical or biological sciences,

2. Section 174 also excludes from eligibility for expensing (1) expenditures for the acquisition or improvement of depreciable property, or land, to be used in connection with research, and (2) expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas.

engineering, or computer science[3]—in which case the information is deemed technological in nature—or on other principles, such as those of economics—in which case the information is not to be treated as technological in nature. For example, information relating to financial services or similar products (such as new types of variable annuities or legal forms) or advertising does not qualify as technological in nature.

Process of experimentation

The term process of experimentation means a process involving the evaluation of more than one alternative designed to achieve a result where the means of achieving that result is uncertain at the outset. This may involve developing one or more hypotheses, testing and analyzing those hypotheses (through, for example, modeling or simulation), and refining or discarding the hypotheses as part of a sequential design process to develop the overall component.

Thus, for example, costs of developing a new or improved business component are not eligible for the credit if the method of reaching the desired objective (the new or improved product characteristics) is readily discernible and applicable as of the beginning of the research activities, so that true experimentation in the scientific or laboratory sense would not have to be undertaken to develop, test, and

3. Research does not rely on the principles of computer science merely because a computer is employed. Research may be treated as undertaken to discover information that is technological in nature, however, if the research is intended to expand or refine existing principles of computer science.

choose among viable alternatives. On the other hand, costs of experiments undertaken by chemists or physicians in developing and testing a new drug are eligible for the credit because the researchers are engaged in scientific experimentation. Similarly, engineers who design a new computer system, or who design improved or new integrated circuits for use in computer or other electronic products, are engaged in qualified research because the design of those items is uncertain at the outset and can only be determined through a process of experimentation relating to specific design hypotheses and decisions as described above.

Functional purposes

Under the conference agreement, research is treated as conducted for a functional purpose only if it relates to a new or improved function, performance, reliability, or quality. (Activities undertaken to assure achievement of the intended function, performance, etc. of the business component after the beginning of commercial production of the component do not constitute qualified experimentation.) The conference agreement also provides that research relating to style, taste, cosmetic, or seasonal design factors is not treated as conducted for a functional purpose and hence is not eligible for the credit.

Application of tests

The term business component means a product, process, computer software, technique, formula, or invention that is to be held for sale, lease, or license, or is to be used by the taxpayer in a trade or business of a taxpayer. If the requirements described above are not met with respect to a product,

etc. but are met with respect to one or more elements thereof, the term business component means the most significant set of elements of such product, etc. with respect to which all requirements are met.

Thus, the requirements are applied first at the level of the entire product, etc. to be offered for sale, etc. by the taxpayer. If all aspects of such requirements are not met at that level, the test applies at the most significant subset of elements of the product, etc. This "shrinking back" of the product is to continue until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test. Treasury regulations may prescribe rules for applying these rules where a research activity relates to more than one business component.

A plant process, machinery, or technique for commercial production of a business component is treated as a different component than the product being produced. Thus, research relating to the development of a new or improved production process is not eligible for the credit unless the definition of qualified research is met separately with respect to such production process research, without taking into account research relating to the development of the product.

Internal-use computer software

Under a specific rule in the conference agreement, research with respect to computer software that is developed by or for the benefit of the taxpayer primarily for the taxpayer's own internal use is eligible for the credit only if the software

is used in (1) qualified research (other than the development of the internal-use software itself) undertaken by the taxpayer, or (2) a production process that meets the requirements for the credit (e.g., where the taxpayer is developing robotics and software for the robotics for use in operating a manufacturing process, and the taxpayer's research costs of developing the robotics are eligible for the credit). Any other research activities with respect to internal-use software are ineligible for the credit except to the extent provided in Treasury regulations. Accordingly, the costs of developing software are not eligible for the credit where the software is used internally, for example, in general and administrative functions (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services), except to the extent permitted by Treasury regulations.

The conferees intend that these regulations will make the costs of new or improved internal-use software eligible for the credit only if the taxpayer can establish, in addition to satisfying the general requirements for credit eligibility, (1) that the software is innovative (as where the software results in a reduction in cost, or improvement in speed, that is substantial and economically significant); (2) that the software development involves significant economic risk (as where the taxpayer commits substantial resources to the development and also there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period); and (3) that the software is not commercially available for use by the taxpayer (as where the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that

would satisfy the first two requirements just stated). The conferees intend that these regulations are to apply as of the effective date of the new specific rule relating to internal-use software; i.e., internal-use computer software costs that qualify under the three-part test set forth in this paragraph are eligible for the research credit even if incurred prior to issuance of such final regulations.

The specific rule in the conference agreement relating to internal-use computer software is not intended to apply to the development costs of a new or improved package of software and hardware developed together by the taxpayer as a single product, of which the software is an integral part, that is used directly by the taxpayer in providing technological services in its trade or business to customers. For example, the specific rule would not apply where a taxpayer develops together a new or improved high technology medical or industrial instrument containing software that processes and displays data received by the instrument, or where a telecommunications company develops a package of new or improved switching equipment plus software to operate the switches. In these cases, eligibility for the incremental research tax credit is to be determined by examining the combined hardware-software product as a single product, and thus the specific rule applicable to internal-use computer software would not apply to the combined hardware-software product.

In the case of computer software costs incurred in taxable years before the effective date for the new specific rule, the eligibility of such costs for the research credit is to be determined in the same manner as the eligibility of hardware

product costs. The conferees expect and have been assured by the Treasury Department that guidance to this effect is to be promulgated on an expedited basis.

Excluded activities

The conference agreement specifies that expenditures incurred in certain research, research-related, or nonresearch activities are excluded from eligibility for the credit, without reference to the requirements described above relating to technological information, process of experimentation, and functional purposes.

Post-research activities.—The conference agreement provides that activities with respect to a business component after the beginning of commercial production of the component cannot qualify as qualified research. Thus, no expenditures relating to a business component are eligible for the credit after the component has been developed to the point where it either meets the basic functional and economic requirements of the taxpayer for such component or is ready for commercial sale or use.[4] For example, the credit is not

4. The exclusion from credit-eligibility for activities with respect to a business component after the beginning of commercial production of the component does not preclude the costs of significant improvements in an existing product from eligibility for the credit. Thus, for example, the expenses of an automobile manufacturer in developing, through a process of experimentation, a significantly more efficient and reliable diesel fuel injector are eligible for the incremental research tax credit even though the research expenses are incurred during or after production by the manufacturer of

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available for such expenditures as the costs of preproduction planning for a finished business component, "tooling-up" for production, trial production runs, "trouble-shooting" involving detecting faults in production equipment or processes, accumulation of data relating to production processes, and the cost of "debugging" product flaws.

By way of further illustration, the credit is not available for costs of additional clinical testing of a pharmaceutical product after the product is made commercially available to the general public. However, the clinical testing in the United States of a product prior to production for sale in this country, or clinical testing seeking to establish new functional uses, characteristics, indications, combinations, dosages, or delivery forms as improvements to an existing product, is eligible for the credit. Thus, research (e.g., body chemistry research) undertaken on a product approved for one specified indication to determine its effectiveness and safety for other potential indications is eligible for the credit. Similarly, testing a drug currently used to treat hypertension for a new anti-cancer application, and testing an antibiotic in combination with a steroid to determine its therapeutic value as a potential new anti-inflammatory drug, would be eligible for the credit.

Adaptation.—The conference agreement provides that adaptation of an existing business component to a particular

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automobile engines containing the existing (unimproved) diesel fuel injector. However, the costs of any activities of the automobile manufacturer with respect to the improved diesel fuel injector after the beginning of commercial production of the improved diesel fuel injector would not be eligible for the research credit.

requirement or customer's need is not eligible for the credit. Thus, for example, the costs of modifying an existing computer software item for a particular customer are not eligible for the credit. However, the mere fact that an item is intended for a specific customer does not disqualify otherwise qualified research costs of the item (assuming that the research is not funded by the customer).

Surveys, studies, etc.—The conference agreement provides that the credit is not available for the costs of efficiency surveys, activities (including studies) related to management functions or techniques, market research, market testing and development (including advertising or promotions), routine data collections, or routine or ordinary testing or inspection of materials or business items for quality control. Management functions and techniques include such items as preparation of financial data and analysis, development of employee training programs and management organization plans, and management-based changes in production processes (such as rearranging work stations on an assembly line).

Duplication.—The conference agreement provides that the credit does not apply to research related to the reproduction of an existing business component (in whole or in part) of another person from a physical examination of the component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such component. While such "reverse engineering" activities thus are not eligible for the credit, the exclusion for duplication does not apply merely because the taxpayer examines a competitor's product in developing a different

component through a process of otherwise qualified experimentation requiring the testing of viable alternatives and based on the knowledge gained from such tests.

Additional exclusions

As under present law, the conference agreement excludes from eligibility for the credit expenditures for research (1) that is conducted outside the United States; (2) in the social sciences (including economics, business management, and behavioral sciences), arts, or humanities; or (3) to the extent funded by any person (or governmental entity) other than the taxpayer, whether by grant, contract, or otherwise.

Effect on section 174 definition

No inference is intended from the rules in the conference agreement defining research for purposes of the incremental credit as to the scope of the term "research or experimental" for purposes of the section 174 expensing deduction.

d. Qualified expenditures

The conference agreement follows the House bill.

e. University basic research credit

The conference agreement is the same as the House bill and the Senate amendment, except that the university basic research credit provisions are effective for taxable years beginning after December 31, 1986.

Appendix E

f. Credit use limitation

The conference agreement follows the House bill and the Senate amendment.

g. Effective date

The extension of the credit is effective for taxable years ending after December 31, 1985. The credit will not apply to amounts paid or incurred after December 31, 1988. The modifications to the credit made by the conference agreement are effective for taxable years beginning after December 31, 1985,[5] except that the modifications relating to the university basic research credit are effective for taxable years beginning after December 31, 1986.

2. Augmented charitable deduction for certain donations of scientific equipment

Present Law

Under a special rule, corporations are allowed an augmented charitable deduction for donations of newly manufactured scientific equipment to a college or university for research use in the physical or biological sciences (sec. 170(e)(4)).

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5. In computing the research credit for taxable years beginning after December 31, 1985, base-period expenditures for taxable years beginning before January 1, 1986 are to be determined under the credit definition of qualified research that was applicable in such base-period years and are not to be redetermined under the definition of qualified research in the conference agreement.

Appendix E

House Bill

The House bill expands the category of eligible donees under the special rule in section 170(e)(4) to include certain tax-exempt scientific research organizations, effective for taxable years beginning after December 31, 1985.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill.

3. Tax credit for orphan drug clinical testing

Present Law

A 50-percent tax credit is allowed for expenditures incurred in clinical testing of certain drugs for rare diseases or conditions (sec. 28). Under present law, the credit will not apply to amounts paid or incurred after December 31, 1987.

House Bill

The House bill extends the tax credit for clinical testing of orphan drugs for one additional year (i.e., through December 31, 1988).

Appendix E

Senate Amendment

The Senate amendment makes permanent the orphan drug credit.

Conference Agreement

The conference agreement extends the orphan drug credit for three additional years (i.e., through December 31, 1990).

D. Rapid Amortization Provisions

1. Trademark and trade name expenditures

Present Law

Taxpayers may elect to amortize over a period of at least 60 months expenditures for the acquisition, protection, expansion, registration, or defense of a trademark or trade name, other than an expenditure which is part of the consideration for an existing trademark or trade name.

House Bill

The House bill repeals the election. Trademark and trade name expenditures are therefore generally capitalized and recovered on a disposition of the asset.

The provision is generally effective for expenditures paid or incurred on or after January 1, 1986.

Appendix E

However, present law applies to expenditures incurred: (1) pursuant to a written contract that was binding as of September 25, 1985; or (2) with respect to development, protection, expansion, registration or defense commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date; provided in each case the trademark or trade name is placed in service before January 1, 1988.

Senate Amendment

The Senate amendment is the same as the House bill. The Senate provision is generally effective for expenditures paid or incurred after December 31, 1986. However, present law applies to expenditures incurred: (1) pursuant to a written contract that was binding as of March 1, 1986; or (2) with respect to development, protection, expansion, registration or defense commenced as of March 1, 1986, if the lesser of $1 million or 5 percent of cost has been incurred or committed by the date, provided in each case the trademark or trade name is placed in service before January 1, 1988.

Conference Agreement

The conference agreement follows the Senate amendment.

2. Pollution control facilities

Present Law

Taxpayers may elect to amortize over a 60-month period the cost of a qualifying certified pollution control facility

used in connection with a plant that was in operation before 1976. To the extent that a pollution control facility has a useful life in excess of 15 years, a portion of the facility's cost is not eligible for 60-month amortization, but must be recovered through depreciation.

House Bill

The House bill repeals the election. Expenditures for pollution control facilities would therefore be recovered in accordance with the applicable depreciation schedules. The repeal is generally effective for expenditures paid or incurred on or after January 1, 1986.

However, present law applies to expenditures incurred: (1) pursuant to a written contract that was binding as of September 25, 1985; or (2) with respect to facilities, construction of which is commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date; provided in each case the facility is placed in service before January 1, 1988.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the Senate amendment.

Appendix E

3. Qualified railroad grading and tunnel bores

Present Law

Domestic railroad common carriers may elect to amortize the cost of qualified railroad grading and tunnel bores over a 50 year period. "Qualified railroad grading and tunnel bores" include all land improvements (including tunneling) necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed of right-of-way for railroad track.

House Bill

Under the House bill, the election is repealed. Expenditures for railroad grading and tunnel bores would therefore be capitalized and recovered on disposition of the asset.

In addition, special ACRS treatment is provided for a particular railroad disaster and involuntary conversion treatment of insurance proceeds in that case is specified.

The repeal of the election generally applies to expenses paid or incurred on or after January 1, 1986. However, present law continues to apply to expenditures incurred: (1) pursuant to a written contract that was binding as of September 25, 1985; or (2) with respect to construction, reconstruction, alteration, improvement, replacement or restoration commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date, provided in each case the improvements are placed in service before January 1, 1988.